Corporate Advisor

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Lessons Learned From First Wave Of Regulation FD Enforcement Actions

The SEC recently brought its first enforcement actions under Regulation FD. These actions—consisting of three administrative proceedings and one report of investigation—provide important insight to public companies as to what the SEC considers to be a violation of Regulation FD.

Regulation FD

Regulation FD, which took effect on October 23, 2000, represents the SEC's first attempt at direct regulation of communications between public companies and investment professionals. Regulation FD prohibits a company from intentionally disclosing material nonpublic information to specified types of market professionals, such as securities analysts and investment advisers, or to securityholders, unless the company publicly discloses the information simultaneously. In addition, if a company non-intentionally discloses material nonpublic information to persons covered by Regulation FD, the company must publicly disclose the information as soon as reasonably practicable after any director, executive officer, investor relations or public relations officer, or other person with similar functions, learns of the disclosure of material nonpublic information, but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange.

Since the adoption of Regulation FD, public companies have struggled with determining appropriate methods for engaging in dialogue with the investment community.

Lessons Learned

The recent SEC enforcement actions provide public companies with guidance as to how they can minimize the risk of violating Regulation FD.

Meetings with Analysts

- If analysts have incorrectly interpreted information that has been publicly disclosed by the company, the safest way to correct the misinterpretation is to make additional public disclosure, rather than to engage in one-on-one conversations. Even if the company believes the information it is conveying has already been publicly disclosed, correcting an analyst's interpretation of that information in a private communication with the analyst is risky. One of the SEC actions alleged that the company had disclosed material nonpublic information during one-on-one conversations initiated by the company where the company addressed inconsistencies between analyst projections and the company's prior public disclosures. While there are situations where it may be permissible to call an analyst's attention to a discrepancy between information presented in his or her financial model and conflicting information that previously has been publicly disclosed by the company, the SEC actions highlight the risk of attempting to correct a misinterpretation or error—particularly a misinterpretation or error that is widespread—through private conversations.

- Companies concerned with the accuracy of earnings estimates published by analysts should disclose the company's own estimates in a press release or other qualifying public forum rather than rely on analysts to derive estimates from historical results and general statements made by the company. Providing analysts or investors with guidance about the company's projected operating results in one-on-one conversations or other limited-access settings is likely to be viewed by the SEC as a violation of Regulation FD. Of course, companies have no obligation to provide earnings estimates, and some companies that previously provided guidance have stopped doing so.
- Companies should not use code words that have special meanings unless the meanings are disclosed publicly. In one case, a company representative told several analysts during one-on-one conversations that when the company used the term "significant" it intended to signal a rate of change of 25% or more. The SEC's view in the enforcement action relating to this case was that the company should have publicly disclosed its definition of the term "significant" on a public conference call or in a press release, and not in one-on-one conversations.
- Companies should ensure that representatives participating in an analyst, investor or technology conference or other similar event understand whether disclosure of material nonpublic information at the event would violate Regulation FD. In one of the SEC enforcement actions, a company officer participating in an invitation-only technology conference hosted by an investment bank reported a positive trend in the company's sales pipeline, which was more optimistic than the information disclosed three weeks earlier during the company's quarterly earnings call. Although analyst conferences attended by the company's representatives were normally broadcast to the public, the company's director of investor relations knew that this particular technology conference would not be webcast. However, the director of investor relations had not informed the company's speaker of this fact. The SEC's position was that disclosure of material nonpublic information at the conference by the company's speaker violated Regulation FD. This enforcement action also highlights the fact that Regulation FD applies to both positive and negative information.

Non-Intentional Disclosure

- Company representatives participating in conversations with analysts should be fully informed about what information is publicly available so they can avoid inadvertent disclosure based on the mistaken belief that the information is already publicly known. One of the SEC enforcement actions involved the disclosure, during a one-on-one conversation with a portfolio manager, of the signing of an OEM agreement that had not been publicly announced but that was alluded to on the company's website. During the conversation with the portfolio manager, the CEO asked the other company representative participating in the conversation whether he could discuss something that was posted on the company's website. The other company representative, apparently unaware that the CEO was referring to the OEM agreement, said that he could. Although the SEC determined that the disclosure was non-intentional, as a result of this miscommunication the company was required to make a prompt public disclosure of the information.

- Company representatives participating in conversations where material nonpublic information is inadvertently disclosed should act immediately to prevent the disclosure of additional material nonpublic information. In the case described above, the other company representative participating in the call with the CEO recognized that the OEM agreement had not been publicly disclosed and that the CEO should not have been discussing the subject. Nevertheless, the other company representative did not interrupt the CEO to prevent further disclosure.
- Companies must make prompt public disclosure of any information that is non-intentionally disclosed. Until the information is publicly disclosed, company representatives should not repeat the non-intentionally disclosed information in limited-access settings. In the case described above, the CEO disclosed the OEM agreement to additional investment professionals in an email later the same day and during a one-on-one conversation the following day. However, at the time of these disclosures, the company had not publicly disclosed the OEM agreement.
- Company representatives should use scripts and/or talking points to help ensure that material nonpublic information is not disclosed non-intentionally during one-on-one conversations or at limited-access events.

Determinations of Materiality

- Company representatives should confer with legal counsel when determining whether information is material and/or nonpublic. In one of the SEC actions, a company officer consulted with internal legal counsel who advised the officer that the information was not material or nonpublic. Even though the SEC concluded that the lawyer's advice was in error, the fact that advice of counsel was sought and given in good faith prior to the disclosure resulted in the SEC issuing a report of investigation, rather than instituting an enforcement action. However, the SEC stated that where an officer knows that the information would be important to a reasonable investor, the officer cannot seek counsel's consent as a shield from liability. The SEC also noted that reliance on legal counsel will not necessarily provide a successful defense in all future cases.
- Companies should assume that any information relating to earnings guidance, including the characterization of earnings estimates as "too high" or "aggressive," will be considered

material.

- Even though the SEC has stated that it will not second-guess companies on close materiality judgments, the practical reality is that the SEC will assess the materiality of information in hindsight. Whenever there is a significant change in trading volume or market price following the company's disclosure in a nonpublic forum of information believed to be immaterial, the company should immediately reevaluate its original materiality determination. If, in hindsight, the information appears to have been material, the company should make prompt public disclosure of that information. Companies should also consider the actions of analysts in response to the disclosure, such as whether analysts change their financial models, in assessing whether the company's initial materiality judgment was correct. In each of the enforcement actions, the SEC concluded that the selective disclosure was material, based in part on the trading volume, market price and/or actions of analysts following disclosure of the information.
- Companies should consider utilizing their disclosure committees to assess the adequacy of disclosure policies and practices in light of the recent SEC actions under Regulation FD, and to help assess the materiality of information that might be publicly disclosed.

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