October 29, 2010

SEC Brings Regulation FD Enforcement Actions In respect of *Implied* Disclosure to Analysts

On October 21, 2010, the Securities and Exchange Commission (the "SEC") announced enforcement actions against Office Depot, Inc. and its CEO and then-CFO for alleged violations of Regulation FD and Section 13(a) of the Securities Exchange Act of 1934. The actions were based upon selective communications to analysts and certain shareholders that implied that the company would not meet analysts' quarterly earnings estimates for the company. The company and the two executives agreed to settle the SEC charges, without admitting or denying liability.

Regulation FD prohibits SEC reporting issuers (other than foreign private issuers), and persons acting on their behalf, from disclosing material nonpublic information to securities analysts, institutional investors or other enumerated persons without disclosing that information to the public. In the words of the SEC, "Regulation FD is designed to level the playing field so that all investors receive the information at the same time."

The enforcement actions illustrate the broad reach of Regulation FD. Although no material nonpublic information was provided expressly to analysts and no specific references were made to the company or its prospects, the message that the company would not meet analysts' expectations was "signaled" via references to recent public statements of comparable companies regarding the impact of the slowing economy on their earnings.

Facts Alleged by the SEC

Shortly before the end of the 2007 second quarter, the company's CEO informed the board of directors and the executive committee that the company would likely not meet analysts' estimates for the second quarter.

In an effort to get analysts to lower their estimates without having to issue a press release ahead of the close of the quarter, the CEO and CFO orchestrated one-on-one calls with the analysts covering the company ostensibly to "touch base." The CFO helped draft talking points for the calls. The calls were made following discussions between the CEO and CFO as to how to encourage analysts to revisit their estimates. The CEO further suggested that the company point out on the calls what the company had said to the market four and six weeks earlier.

The calls were made by the director of investor relations. The CEO and CFO were in communication with the director of investor relations during and after the calls. They did not, however, participate in the calls.

During the calls, the company did not expressly state that it would not meet analysts' expectations; instead, it referred to (a) the slowing of the economy, (b) recent public statements of comparable companies about the impact of the slowing economy on their earnings and (c) the fact that the company's earnings model contemplated stable economic conditions. The analysts were also reminded of the company's prior cautionary public statements. The calls mirrored the approach that was agreed between the CEO and CFO during their earlier conversation.

Separately, the director of investor relations, following instructions from the CFO given after concerns were raised by two analysts about the lack of a press release, called the company's top twenty institutional investors and conveyed the same message to them.

The analysts lowered their estimates for the quarter and the share price of the company dropped significantly. Six days after the calls to analysts began, the company filed a current report on Form 8-K publicly disclosing that its earnings would be "negatively impacted due to continued soft economic conditions."

The SEC also identified the following factors:

No prior calls. Prior to the calls in question, the company had not regularly initiated these types of calls to all analysts covering the company.

Timing of the calls. The calls were made at the end of the quarter, reinforcing the view that the statements were not based on estimates but rather on actual information.

Knowledge of concerns. The company continued to make the calls despite the CFO and director of investor relations being notified of some analysts' concerns regarding the lack of public disclosure.

Lack of Regulation FD policies. The company did not have written Regulation FD policies or procedures at the time and had never conducted any formal Regulation FD training prior to June 2007, although certain guidance and updates had occasionally been circulated by its general counsel.

Practice Points

In addition to the clear message that implicit signals intended to convey material nonpublic information can be subject to the same regulatory scrutiny as direct statements, these enforcement actions highlight the risks of communications with analysts near the end of a reporting period. The focus on implicit signals is but a variation on an old theme, namely that when communicating with securities industry professionals, companies may not use "code" words to selectively disclose information that they could not selectively disclose expressly. The risks posed by statements made near the end of a reporting period have been highlighted by the SEC staff in the past – investors may reasonably infer that statements made well into, or near the end of, a reporting period are no longer estimates but rather confirmations.

We use this opportunity to reiterate the following practice points based on prior SEC guidance and enforcement actions:

- The SEC is serious about monitoring compliance with and enforcing Regulation FD.
- Individuals risk becoming subject to enforcement actions where they play an active role in the violation.
- Non-intentional selective disclosure must be remedied right away and there should be no further disclosure other than a press release (or other FD compliant disclosure).
- Private communications of material, nonpublic information to securities professionals are not a proper way to supplement a prior public disclosure that the company determines to have been misunderstood or misinterpreted.
- Senior investor relations officers (investor relations directors as well as key spokespersons such as CFOs and CEOs) must be proactive and vigilant in monitoring public disclosure and acting on Regulation FD violations.
- Companies should establish and maintain effective policies and procedures with respect to external communications. In addition, having a company policy on proper disclosure will not help if it is not followed.
- Selective disclosure problems can arise out of a failure to disclose "good news," as well as a failure to disclose negative news, in contrast to insider trading situations where the positive or negative impact of the nonpublic information may be relevant.

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