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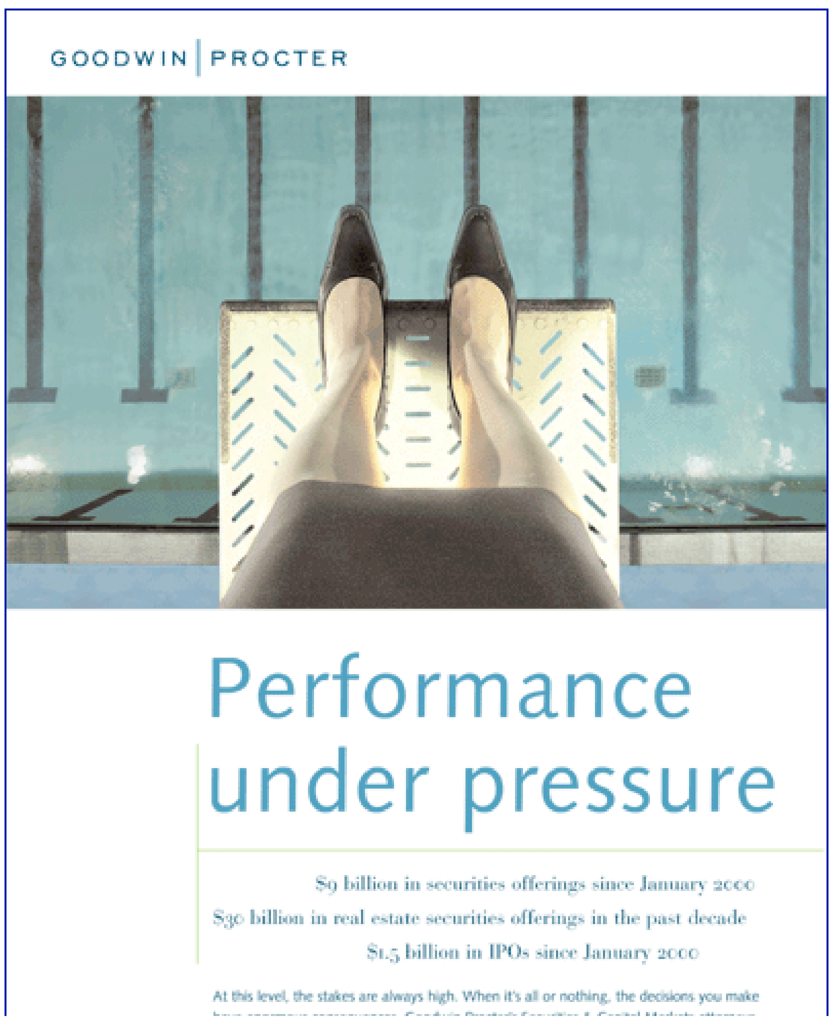
Second Article

Some Rules of the Road for Taking it to The Street: The Impact of Item 12 of Form 8-K and Regulation FD on Quarterly Earnings Announcements and Related Disclosure [PART 2]

GOODWIN | PROCTER

By Robert Whalen and Eric Graham

For Part 1 of this article click here



Implications of Recent Regulation FD Enforcement Actions

As part of the quarterly earnings release process, many companies meet one-on-one with analysts to discuss the results from the last quarter and expectations for the future. Similar discussions also may take place at investor or analyst conferences or in private meetings with significant stockholders. These situations present real risks under Regulation FD. The SEC has remained true to its promise to continue to focus on enforcing Regulation FD and preventing selective disclosure. As recently as September 2003, the SEC issued cease-and-desist orders, as well as civil fines, against Schering-Plough Corporation and its former chairman and CEO for violations of Regulation FD. Consequently, it remains important to remember the prohibitions of Regulation FD, especially in connection with the quarterly earnings release process, and to learn the lessons taught by the enforcement actions and investigation report brought to date.

Regulation FD generally requires that any disclosure of material information by public companies be made in a manner that provides for broad public disclosure, rather than through "selective disclosure" to a limited number of market participants, such as securities analysts. Regulation FD specifically requires that whenever an issuer, or a person acting on its behalf (generally, senior officials) discloses material nonpublic information selectively to securities market professionals or security holders, the issuer must make public disclosure of the information simultaneously (for intentional disclosures), or promptly (for non-intentional disclosures).

When it adopted Regulation FD in 2000 the SEC warned:

> "When an issuer official engages in a **private discussion** with an analyst who is seeking **guidance about earnings estimates**, he or she takes on a **high degree of risk** under Regulation FD. If the issuer official communicates **selectively** to the analyst nonpublic information that the company's **anticipated earnings will be higher than, lower than, or even the same as** what analysts have been forecasting, the issuer likely will have violated Regulation FD. **This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces."** (emphasis added).

On November 25, 2002, the SEC completed its first enforcement actions against companies for violations of Regulation FD, issuing cease-and-desist orders against (1) Raytheon Company and its CFO, (2) Siebel Systems, Inc. and (3) Secure Computing Corporation and its CEO for violations of Regulation FD's prohibition of the selective disclosure of material nonpublic information. The SEC also issued an investigation report relating to selective disclosure by Motorola, Inc., but did not seek enforcement in that matter. And more recently, on September 9, 2003, the SEC issued a cease-and-desist order, as well as civil fines against Schering-Plough Corporation and its former chairman and CEO personally for violations of Regulation FD.

Regulation FD, which became effective in October 2000, prohibits public companies from selectively disclosing material nonpublic information to securities markets professionals or to security holders who might trade on the basis of that information. Under Regulation FD, any disclosure of material nonpublic information must be made by means of broad public disclosure (*e.g.*, press release or Form 8-K), and cannot be made on a one-on-one or other selective basis.

In the SEC enforcement actions and investigation report described in more detail below, the SEC reinforced the following lessons for public companies:

- If a company officer engages in a private discussion with an analyst concerning earning estimates, the company is taking a "high degree of risk" of violating Regulation FD's prohibition on selective disclosure. In the *Raytheon* case, the SEC stated that "[i]f the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD."

- If during a private discussion with an analyst a company officer provides a more specific quantitative definition (*e.g.*, specific numerical guidance) clarifying qualitative terms that have been used in prior public disclosure (*e.g.*, press release or earnings conference call), it is likely that the company will have violated Regulation FD. In the *Motorola* investigation, the SEC found a violation of Regulation FD when an officer privately disclosed to an analyst that the terms "significant" or "significantly" as used by Motorola in prior public statements depicted a rate of change of "25% or more."

- Companies should be very cautious in making any statements at industry or investor conferences, especially when responding to questions, unless there is a simultaneous webcast of the conference (preceded by advance public notice) or the company simultaneously issues a press release or files a Form 8-K disclosing the statements to be made by the officer. The *Siebel* case illustrates the risks involved in connection with participating in such conferences.

- Companies must be careful when posting information on their websites to ensure that such information does not include or refer to material nonpublic information. If a material development occurs, a company needs to issue a press release or make other appropriate public disclosure before posting information on its website. If such prior public disclosure is not made, disclosing to an investor the existence of the information on the website constitutes a violation of Regulation FD. The

Secure Computing case is an example of this type of Regulation FD violation.

- Company officers should be aware that indirect and nonverbal communications may be viewed as contributing to selective disclosure and that, as the SEC has stated, "[i]ssuers may not evade the public disclosure requirements of Regulation FD by using 'code' words or 'winks and nods' to convey material nonpublic information during private conversations." While the *Schering-Plough* action ultimately turned on the statements made by the CEO, it would be inadvisable to ignore the emphasis given to the "tone, emphasis and demeanor" portion of the order.
- Non-intentional selective disclosures of material nonpublic information should be corrected immediately by public press release; attempts to ameliorate the situation by providing the same information to a wider group of analysts or other selective disclosures will only compound the problem. Remember that a non-intentional disclosure must be publicly disclosed "promptly" after learning of such disclosure, which means "as soon as reasonably practicable" 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. In this regard, public companies should have an identified group of executives and advisors who constitute a "disclosure team" or "disclosure committee" which is qualified and authorized to immediately investigate, analyze and act upon such non-intentional or unauthorized disclosures. The team should develop a "two minute drill" on how to handle situations such as these.

It also is worthwhile to remember that, as *Raytheon*, *Secure Computing* and *Schering-Plough* demonstrate, the SEC may not only bring an enforcement action against the company, but also against the senior officer who engaged in the conduct that resulted in the Regulation FD violation.

Raytheon: Selective Disclosure of Earnings Guidance to Analysts

On February 7, 2001, Raytheon conducted an investor conference that was publicly available by means of a webcast. During the conference, Raytheon's CFO reiterated guidance that Raytheon's 2001 annual earnings per share would be between $1.55 and $1.70 but did not disclose how earnings would be distributed quarterly throughout the year. Before being contacted by the CFO, analysts attributed a general seasonality to Raytheon's quarterly earnings pattern where the first quarter generally was the weakest and the fourth quarter the strongest, with an ascending slope in between. In 2000, the slope was steep with approximately one-third of earnings occurring in the first two quarters. Prior to their one-on-one conversations with Raytheon's CFO, analysts projected that Raytheon's 2001 earnings would be more evenly distributed.

Following the February 7, 2001 investor conference, Raytheon collected the analysts' models and arranged one-on-one calls. During most of the calls, Raytheon's CFO discussed Raytheon's quarterly and semiannual distribution of projected 2001 earnings, disclosing that Raytheon expected that it would generate the same distribution as in 2000. During or after the call, each analyst revised his or her earnings estimates to conform to the CFO's disclosure by moving projected earnings from the first half of the year to the second half of the year. Those analysts who had published their estimates on First Call prior to their one-on-one conversations with Raytheon's CFO submitted revised estimates to First Call.

In certain instances, the CFO communicated additional, more specific earnings guidance. For example, he told one analyst that the analyst's guidance was high and not in line with Raytheon's guidance, even though Raytheon had not provided any such guidance. The CFO told two other analysts that their guidance for particular Raytheon divisions was "aggressive" or "very aggressive." In another instance, he e-mailed an analyst's assistant to reiterate the earnings guidance he had given to the analyst in the prior one-on-one call.

In concluding that Raytheon and its CFO had violated Regulation FD, the SEC reiterated the guidance provided in the Regulation FD adopting release: "When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a ***high degree of risk*** under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD" (emphasis added).

Motorola: Selective Disclosure of Earnings Guidance to Analysts

On January 11, 2001, Motorola held a webcasted analyst call during which the company estimated that first quarter 2001 sales would be $8.8 billion and earnings would be $.12 per share. On February 23, 2001, Motorola issued a press release stating that as a result of significant weakness in first quarter orders the company no longer expected to achieve the first quarter 2001 sales and earnings guidance issued on the January 11 analyst call.

On a webcast analyst call that followed the February 23 press release, Motorola's president and CEO explained that the company's personal communications segment was "experiencing ***significant*** weakness in orders and sales versus our expectations at the beginning of the quarter" (emphasis added). He also stated that the semiconductor product segment was "experiencing lower sales and ***significantly*** lower orders" and that "[a]ll markets are down compared with the same period last year" (emphasis added).

Following the February 23 call, most analysts lowered their earnings estimates. Motorola's investor relations director believed, however, that many of the analysts were still overstating Motorola's quarterly estimates. As a result, the investor relations director contacted approximately 15 analysts to discuss their models and on at least 10 of these calls specifically told analysts that when Motorola uses the terms "significant" or "significantly" it intends to depict a rate of change of 25% or more. All of these analysts further revised their models downward following these calls.

The SEC noted that, prior to making the calls to the analysts, the investor relations director sought and obtained the advice of Motorola's in-house legal counsel, who advised him that he could contact the analysts, reiterate the information that had been disclosed on the February 23 analyst call and provide quantitative definitions for certain qualitative terms that had been used on the analyst call. That legal advice was based on counsel's belief that providing a quantitative definition for the term "significant" was not material and that in any event that definition was public for Regulation FD purposes. The latter reasoning was in turn based upon Motorola's position that historically the company relied on sell-side analysts to communicate information from the company to the investing public.

The SEC concluded that there was a substantial likelihood that a reasonable investor would consider it important that Motorola's sales and orders were down by 25% or more for the quarter even though the company had already disclosed that sales and orders were experiencing significant weakness. The very fact that the investor relations director believed that he had to clarify what "significant" meant demonstrated to the SEC that the term had not been understood on the February 23 call to mean "25% or more." As such, the SEC concluded that the specific quantitative figure was material information that had not previously been made public.

The SEC also reiterated and emphasized its view that after-the-fact private communications of material nonpublic information to securities professionals are not the proper way to supplement prior public disclosure that the issuer determines was misunderstood or misinterpreted. Particularly troubling to the SEC was the fact that Motorola knew that even securities professionals had failed to understand the earnings guidance and yet chose to contact only selected analysts to clarify that message rather than make broad public disclosure as required by Regulation FD. The SEC also stated that companies may not use "code" words or "winks and nods" to convey material nonpublic information during private conversations.

The SEC did, however, credit Motorola with seeking and relying, in good faith, on advice of counsel and therefore did not bring an enforcement action against Motorola. But the SEC also stated that such reliance would not be justified where a company official knows or is reckless in not knowing that the information to be selectively disclosed would be important to a reasonable investor, and the SEC will be less likely in future cases to credit reliance on counsel.

Siebel Systems: Selective Disclosure of Business Trends at Industry Conferences

In October 2001, Siebel reported its third quarter 2001 results. In the related public earnings conference call, the CEO stated the company's belief that the environment for information technology had been difficult and that it would continue to be difficult in the short term and at least through the remainder of the year. He also stated that customer spending for technology products and services was continuing to decline.

Following this call, Siebel and Goldman Sachs & Co. discussed the possibility of Siebel participating in a technology conference to be held on November 5 that would involve an informal question and answer session in which the CEO would respond to questions from a Goldman analyst. In advance of the conference, Goldman provided the CEO with a list of questions that the analyst planned to ask. Among the questions was whether Siebel had any evidence that the software market was getting any better or worse in the fourth quarter. Goldman also provided Siebel with a list of the attendees for the conference, which included broker-dealers, investment advisers, investment companies and institutional shareholders, including the largest institutional holder of Siebel's stock.

At the conference, the Goldman analyst asked Siebel's CEO various questions relating to the fourth quarter outlook. In particular, the analyst asked Siebel's CEO to provide an "update of what you're seeing after September, maybe how the economy is looking and how the software business is looking during the month of October," to which the CEO responded: "The business decisions appear to be quite normal right now, and so we're pretty optimistic about what we're seeing at this time…so right now it appears we're seeing a return to normal behavior in IT buying patterns." The analyst also asked the CEO to characterize sales activity levels and linearity throughout the fourth quarter, to which he replied: "I think the linearity of this Q4 will be about what we saw in Q4 of the previous two years…the behavior of the market appears normal." To additional, similar questions the CEO responded that the signing of customer contracts had been slowing down in the third quarter but in the fourth quarter was back to a more normal rate, and that his concern that the business would deteriorate in the fourth quarter, which he communicated in the company's third quarter conference call, was not playing out.

Siebel did not simultaneously disclose to the public the statements made by the CEO at the conference – there was no webcast of the conference, nor did Siebel issue a press release or file a Form 8-K containing these statements. At 10 a.m. on November 5, when the CEO began speaking at the conference, Siebel's stock was trading at $18.98 per share. The CEO spoke for approximately 40 minutes, with the remarks described above occurring in the first 10 minutes. By the end of his presentation, the stock price had increased to $19.81 per share in heavy volume. By 1 p.m., when the first reports of the CEO's remarks began to appear in the media, the stock had increased to $20.15 per share (an increase of 16.5% over the prior day's closing price) on double the average daily trading volume. Certain attendees at the conference purchased Siebel stock prior to 1 p.m. In addition, a Goldman employee who attended the conference sent an e-mail to Goldman's internal message board (which is accessible by Goldman's sales and trading desks) reporting the "return to normalcy" and "Q4 linearity" comments made by the CEO at the conference. Goldman was the most active firm trading Siebel stock that day.

In its legal analysis, the SEC noted that the CEO's selective disclosures were made to the group of market professionals specifically targeted by Regulation FD. Thus, the disclosures were made to persons outside of the company under circumstances in which it was reasonably foreseeable that such persons would purchase or sell the company's securities on the basis of those disclosures. The SEC concluded that the CEO's statements were material in that they reflected trends in the company's sales pipeline that a reasonable investor would have considered important in making an investment decision regarding the company's stock.

Furthermore, according to the SEC, the information disclosed by the CEO sharply contrasted with statements he made in October 2001 when he explained the company's fourth quarter outlook in a public conference call. Certain attendees at the conference who received this information recognized that the CEO was communicating new information about the company's business because immediately following his remarks they purchased Siebel stock or communicated to others who traded.

The SEC also concluded that the CEO's remarks were intentional within the meaning of Regulation FD because the CEO knew that his remarks reflected material nonpublic information and the company's investor relations director knew that the conference was not being webcast or otherwise disseminated to the public. Accordingly, the SEC concluded that the company knew or was reckless in not knowing that it was selectively disclosing material nonpublic information at the conference.

Secure Computing: Selective Disclosure of a Material Agreement

In early 2002, Secure entered into an original equipment manufacturing (OEM) agreement pursuant to which one of the nation's largest computer networking companies would buy Secure's product and integrate it into a product of its own. Neither Secure nor the buyer made any public announcement of the arrangement, and the buyer's consent was required in order for Secure to disclose the arrangement. This consent was contingent upon the buyer's sales force selling the product to "beta" customers who would test the product and provide feedback and customer testimonials that could be used in the press release.

After executing the agreement, Secure posted an electronic user manual containing technical information about the product on the buyer's website for use by its sales force and beta customers. At the buyer's request, Secure then posted information and software downloads on Secure's website for use by the buyer's sales force and for customers who were evaluating the product. At this time, neither Secure nor the buyer had issued a public announcement concerning their agreement nor did their main web pages refer to the deal.

Subsequent to the foregoing events, the CEO of Secure, together with Secure's director of investor relations, conducted a conference call with a portfolio manager of an investment advisory firm. A member of a brokerage firm that follows Secure arranged for and participated on the call. During the call, the CEO was asked questions about the product that was the subject of the OEM agreement. The CEO then asked the investor relations director whether he could discuss something that had been posted on the company's and the buyer's website (he did not identify the name of the buyer), to which the investor relations director, unaware that the CEO was referring to the product that related to the OEM agreement, confirmed that he could. The CEO then proceeded to disclose to the portfolio manager the existence of the OEM agreement. The director of investor relations immediately recognized that the OEM agreement had not been publicly announced and that the CEO should not be discussing the matter, but did not interrupt him. The broker participating on the call had not previously been aware of the OEM agreement and immediately e-mailed the Secure web page address to the brokerage firm's sales force.

Following the call, the investor relations director attempted to reach the CEO and left him a voicemail informing him that he had disclosed nonpublic information during the call, but before the CEO received that message he had responded to an e-mail from the brokerage firm's managing partner who had inquired about the OEM agreement. In his response, the CEO stated that there had not been a press release yet and alluded to the fact that deal was a good one for Secure. After receiving the investor relations director's voicemail, the CEO called the managing partner and requested that he keep the information concerning the OEM agreement confidential. At the end of the day, Secure's stock closed 8% above the prior day's closing price on trading volume that was more than double that of the day before.

In response to investor inquiries the following day about the existence of the OEM agreement, Secure decided that it would have to issue a press release and sought the buyer's consent. During the day, the CEO had additional calls with institutional investors, and on at least one of those calls with a portfolio manager of an institutional advisory firm confirmed the existence of the OEM agreement. Following the close of the markets, Secure issued a press release disclosing the OEM agreement. Secure's stock price rose another 7% during the day on volume that was 130% higher than that of the prior day.

The SEC concluded that the initial disclosure of the OEM agreement had been non-intentional. However, Secure subsequently failed to make prompt public disclosure of the OEM agreement and instead again selectively disclosed the existence of the OEM agreement to another institutional advisory firm before issuing the press release.

Schering-Plough. Selective disclosure through a combination of spoken language, tone, emphasis and demeanor.

On September 9, 2003, the SEC issued a cease-and-desist order against Schering-Plough Corporation and its former chairman and CEO for violations of Regulation FD. The company was $1 million and the CEO was fined $50,000 personally.

During one-on-one private meetings with analysts and portfolio managers of four institutional investors, some of which were key shareholders, over a two-day period the CEO disclosed "negative and material, nonpublic information" regarding the company's earnings (*i.e.*, consensus estimates were too high and future earnings would decline). At each meeting the disclosure was made "though a combination of spoken language, tone, emphasis and demeanor." In each case the in-house analyst either downgraded the stock or broadcasted to the portfolio managers that the company was heading for trouble, and the portfolio managers sold heavily. Days later the CEO held a scheduled but private, non-webcast meeting with 25 analysts and portfolio managers where, among other things, he stated that "earnings would be terrible." Later that evening the company issued a press release with lowered earnings guidance.

Schering-Plough's Form 10-Q for the quarter ended June 30, 2002 disclosed: (1) an adverse ruling in patent litigation covering a key product; (2) that generic/OTC versions of the drug would come to market within six months and "would likely have a rapid, sharp and material adverse effect;" (3) the effect may be mitigated if an appeal of the adverse patent ruling was successful; and (4) that the company expected wholesalers to deplete inventories of the drug during the upcoming quarter, with a negative impact on profit. In late September 2002 management ran new projections showing third and fourth quarter 2002 earnings below prior guidance and fiscal year 2003 earnings below analysts' estimates. Up until that point, no guidance as to fiscal year 2003 had yet been given.

During the week of September 30, 2002, the CEO met with four mutual funds. There was no formal presentation, rather a Q&A format was followed. Key statements by the CEO and the SEC's characterization of the same (in italics) were as follows:

- Schering is going to take a "hard hit" in 2003. *"This was materially different from the company's earlier public disclosures..because it conveyed a definitive, as opposed to a contingent, statement not previously disclosed."*
- I do not favor "Schering repurchasing its own shares." *"[This] was materially different than the company's prior public statement that no decision had been made on whether to buy back its shares."*
- Manufacturing costs will increase in 2003 and no significant cost cuts are planned. *"[This] went materially beyond the company's prior public disclosure that its costs had increased during the second quarter of its 2002 fiscal year 'primarily due to a shift in sales towards royalty-bearing products and costs associated with manufacturing issues.'"*
- 2003 will be a "very, very difficult" year, and that "the street" had not sufficiently lowered earnings estimates for the third quarter of 2002. *"Schering had publicly warned that it expected its third-quarter earnings to be 'significantly lower than the comparable period in 2001,' but the company had never publicly commented on Wall Street analysts' earnings estimates for the quarter nor provided any other quantitative guidance suggesting that estimates were too high."*
- The company will not be significantly cutting costs in 2003 and 2003 margins will be negatively impacted by product mix and manufacturing costs. *"[This] went materially beyond the company's prior public disclosures that its costs had increased during the second quarter of its 2002 fiscal year 'primarily due to a shift in sales towards royalty-bearing products and costs associated with manufacturing issues.'"*
- When Claritin goes off patent and is moved to OTC market, revenues from Claritin will "shrink meaningfully" and that the gain of OTC sales will not offset the loss of prescription sales. *"These*

> *statements were materially different from the company's earlier public disclosures that its financial results could suffer depending on the outcome of various contingencies."*

The SEC reiterated that Regulation FD was adopted out of concern that issuers were "disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public" and that "[i]ssuers may not evade the public disclosure requirements of Regulation FD by using 'code' words or 'winks and nods' to convey material nonpublic information during private conversations."

The SEC placed a great deal of emphasis on e-mails and voice-mails following the meeting within the four mutual fund firms to the effect that the "tone" and "confidence level" of the CEO were negative or that the CEO had a "downbeat" demeanor or that the CEO was "more difficult to get information from than the norm." However, it is what the CEO said ultimately, not how he said it or how he presented himself, that violated Regulation FD. This quote from a portfolio manager the day after the meeting is telling:

> "I'll tell you, since I was in the meeting yesterday, .. they clearly are going to miss third quarter and next year numbers. .. It's a big buzz down here because .. no one had any idea why the stock was down yesterday. .. Anyone who didn't meet with them over the last couple of days doesn't have a clue as to what is going on."

The key words to take away from *Schering-Plough* are: "materially different" and "materially beyond" prior public disclosures. They both appear multiple times in the order. For all the emphasis on the "tone, emphasis and demeanor" portion of the order, the real basis for the ruling is the "spoken language" part of the factual record. Had the CEO not **said expressly** things the company had not previously disclosed, his tone, emphasis and demeanor would not have made this a good test case for the SEC.

Regulation FD Best Practices

Taking lessons from the above enforcement actions and investigation report, here are some practical suggestions to minimize the risk of Regulation FD violations:

- Designate a group of executives and advisors in advance as an "emergency disclosure team" which is qualified and authorized to immediately investigate, analyze and act upon non-intentional or unauthorized disclosures (the team should develop a "two minute drill" on how to handle these situations).
- Use a script for presentations and earnings calls, rehearse it and do not deviate from it (consider reviewing transcripts of previous presentations and earnings calls in order to anticipate the types of questions that are likely to be asked).
- Do not confirm or provide guidance on analysts' earning estimates.
- Handle one-on-one calls with analysts or stockholders with extreme caution (at least 2 officers should be present to ensure immediate detection of non-intentional disclosures).
- Develop standard protocols for management presentations at industry conferences (*e.g.*, review slide shows or written materials to determine whether they contain material nonpublic information, adopt procedures similar to those used for quarterly earnings calls, such as adequate notice by press release and public access by simultaneous telephonic means or webcast).
- Consider the use of confidentiality agreements with venture capital investors, other major stockholders or others who need special acce

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Second Article