

**THE SEC'S FIRST ENFORCEMENT
ACTIONS UNDER REGULATION FD:
LESSONS LEARNED, QUESTIONS REMAINING**

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I. Introduction

Regulation FD became effective on October 23, 2000. The SEC intended the Regulation to address a perceived inequity in the way that public companies disseminated information to favored analysts and financial professionals. The Regulation was controversial and subject to much comment and debate, and persons affected have awaited Commission action—particularly through the enforcement division—to clarify its scope. The SEC's two-year silence since the Regulation became effective has only heightened the suspense. On October 25, 2002, the Commission broke its silence when it instituted three settled enforcement actions (all administrative "cease and desist" proceedings) and issued a "Report of Investigation" (a "21(a) Report") relating to Regulation FD. As is often the case with "first out of the box" proceedings, the Commission's actions answered some questions, left others open, and raised new ones. This White Paper provides a short summary of the Commission's recent proceedings and discusses their implications. (Additional details as to the facts alleged in each of these proceedings can be found in the text of the Releases cited below.)

II. The Commission's Recent Enforcement Actions

Regulation FD prohibits a public company (and certain individuals associated with the company who are acting on its behalf) from disclosing material nonpublic information about the company to market professionals and holders of the company's securities who could be expected to trade on the basis of that information, without disclosing the information to the public generally. If the selective disclosure is intentional, the company must make the public disclosure simultaneously. If the selective disclosure is non-intentional, the company must make the public disclosure promptly. The method selected for public disclosure must be reasonably designed to effect broad dissemination. (Most companies have chosen to file a Form 8-K disclosing such information—regardless of whether the company has issued a press release, posted the information on its website or used another disclosure method—to avoid an accusation that it has not disseminated the information broadly.)

The Commission's four recent actions were: *In the Matter of Raytheon Company and Franklyn A. Caine*, Release No. 34-46897; *In the Matter of Secure Computing Corporation and John McNulty*, Release No. 34-46895; *In the Matter of Siebel Systems, Inc.*, Release No. 34-46896, Litigation Release No. 17860, and *Report of Investigation in the Matter of Motorola, Inc.*, Release No. 34-46898.

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Raytheon

In *Raytheon*, the SEC instituted and settled cease and desist proceedings against Raytheon and its CFO. (As with each of the recent matters, the respondents neither admitted nor denied the allegations.) The Commission found that the company (through its CFO) had phoned selected analysts after it had issued *annual* earnings-per-share guidance and provided those analysts with details as to the company's *quarterly* earnings expectations, which information had not been generally distributed. The company also told certain analysts that their estimates of the company's earnings or other financial metrics were too high. (This corrective process—which the Commission believed was common prior to Regulation FD—is known as “walking down the street.”) The SEC also found that, as a result of this process, the analysts had lowered their consensus earnings-per-share estimates, and the company subsequently was able to exceed these lowered estimates.

The SEC concluded that Raytheon's selective disclosures were “intentional” because the CFO “knew or was reckless in not knowing [that the disclosed information was] both material and non-public.” The Commission ordered the company and its CFO to cease and desist from violating Regulation FD, but did not impose any penalties or other sanctions. (Commissioner Campos dissented from the Commission's published order to the extent that the Commission did not impose a penalty, but did not write separately to explain his reasoning.)

Secure Computing

In *Secure Computing*, the Commission alleged that the company (through its CEO) had intentionally made a selective disclosure of information concerning an important pending contract during a March 7, 2002 conference call with certain institutional investors. Interestingly, the day before that call, the CEO had *inadvertently* disclosed the same information during a conference call with a portfolio manager of an investment advisory firm and a representative of a brokerage firm. Prior to the March 6 call, the CEO had asked the Director of Investor Relations (“DIR”) whether he could discuss certain information relating to postings on the company's website. The DIR had not understood that the CEO was referring to information that related to the contract, and had told him that he could discuss the postings. During the call, the DIR recognized that the CEO was revealing information about the contract that the company had not yet publicly disclosed, but did not intervene. After the call, the DIR contacted the CEO (who had taken the call from a different location) and, after some delay, advised him that he had disclosed nonpublic information. The Commission believed that the CEO's disclosure was inadvertent because of the miscommunication between the CEO and the DIR.

On March 7, Secure Computing's management, noting that trading volume in the company's stock was rising dramatically, decided that they needed to issue a press release, and sought approval from the counterparty to the contract to do so. However, prior to the issuance of the press release (which didn't occur until after the close of the market on March 7), the CEO conducted another conference call with institutional

investors and again disclosed the information relating to the contract.

As in the *Raytheon* matter, the Commission did not obtain a monetary sanction (Commissioner Campos, who had dissented from the *Raytheon* opinion because of the Commission's failure to impose a sanction, did not similarly dissent here).

Siebel Systems

According to the SEC, Siebel Systems had provided guidance as to improvements in the company's business prospects at an "invitation-only" analyst conference sponsored by a major investment bank. In preparation for the conference, the company's DIR had provided senior executives with "talking points" that contained only public information. In discussions at the conference, however, the CEO departed from those talking points. Significantly, the Commission's discussion of the facts acknowledged that analyst conferences in which Siebel Systems' senior management participated normally were broadcast to the public, but that this particular conference was not. Further, the DIR had known that the conference would not be broadcast simultaneously, but had not so advised the CEO. The Commission found that these facts demonstrated that the company had engaged in intentional selective disclosure. The Commission further observed that on the day of the conference, the price of Siebel Systems' common stock rose by 20%, and its trading volume doubled. Unlike in the *Raytheon* and *Secure Computing* matters, the Commission insisted on a \$250,000 monetary penalty, which it obtained through filing and settling a suit in federal district court simultaneously with the institution and settlement of the administrative proceeding. (Commissioners Glassman and Atkins dissented from the imposition of the penalty, although they did not offer explanations for doing so.)

Motorola

Finally, in its 21(a) Report in regard to *Motorola*, the Commission considered the applicability of a "reliance on advice of counsel" defense. (The Commission uses 21(a) Reports infrequently, and usually to announce new legal interpretations or enforcement policies. A 21(a) Report typically finds that a violation of the law has occurred, but explains the Commission's decision not to pursue an action. As such, a 21(a) Report usually merits close study. This is the case in *Motorola*.)

In *Motorola*, the Commission found that the company had told the public that its sales were down "significantly." The company subsequently realized that analysts were not appreciating the magnitude of the decline that the company had intended to convey. The company (through its DIR) then telephoned certain analysts and told them that "significantly" meant a decline in sales of 25% or more. The Commission wrote:

When an issuer endeavors to make public disclosure of material information—but later learns that it did not, in fact, fully communicate the intended message, and determines that further disclosure is needed—the proper course of action under Regulation FD is *not* to selectively disclose the corrected message in private

communications with industry professionals, but rather to make additional public disclosure.

The Commission's point here is obvious (although, we note, the company's private guidance was of the same character as its prior public guidance, and the company was not privately changing direction from its public pronouncements). Had these been the only facts presented, the SEC likely would have pursued this matter through a proceeding similar to those involving Raytheon, Secure Computing and Siebel Systems. However, Motorola's DIR had consulted with one of the company's in-house counsel prior to engaging in the private disclosures at issue. Counsel apparently had advised the DIR that the proposed "clarification" that "significant" meant "25% or more" was neither material nor nonpublic. Although the Commission believed that counsel's advice was wrong, it acknowledged that the advice apparently was sought and given in good faith. The SEC noted the standard limitation on the advice-of-counsel defense—that the client must have disclosed all relevant facts to the attorney. The Commission went further, however, and appears to have imposed on corporate officers a responsibility—in certain circumstances—to discount their attorneys' advice as to how the law should be applied to particular facts. As to judgments of materiality, the Commission wrote:

[I]n a case where the officer knows that the information to be selectively disclosed would be important to the reasonable investor, he or she cannot seek out and rely on counsel's consent as a shield against liability. In many cases, an issuer's chief financial officer or investor relations officer may have a keener awareness than company counsel of the significance of information to investors. Consultation with counsel will not relieve the officer from responsibility for disclosure of information that he or she personally knows, or is reckless in not knowing, is material and nonpublic.

The Commission also warned that, having issued this 21(a) Report, it would be unlikely to decline to pursue an enforcement action if presented with similar facts in the future.

The Commission's 21(a) Report also contains a footnote that should give pause to officers who conclude, with or without advice of counsel, that a proposed selective disclosure is immaterial. Footnote 12 describes a situation where an officer relies on counsel but "later learns additional information that puts him or her on notice that the information being disclosed is material and nonpublic, notwithstanding counsel's prior advice." The example that the Commission provides raises the possibility that the Commission will look to officers to engage in ongoing monitoring activities to ensure that their materiality judgment was correct: "[A]n officer may become aware of a very significant market reaction and may learn facts indicating that this reaction was a result of the selective disclosure. At that point, even though the officer's original selective disclosure was not intentional, the issuer has learned that it has made a non-intentional selective disclosure." Nothing in the Regulation FD adopting release suggests such a result; instead, the Commission now appears to have imported into Regulation FD the much-criticized "materiality by hindsight" analysis of Staff Accounting Bulletin 99. As

with SAB 99, the troubling aspect of the SEC's example is that price and volume movements of an issuer's stock usually reflect an amalgam of factors (the "total mix" of information available about the issuer, its sector, and the general economy), and it seems excessive to place on officers an obligation to analyze the relative significance of different factors in order to determine whether their initial disclosure decisions were correct. In particular, how is an officer to determine from market reaction whether he or she made a mistaken materiality judgment, or instead supplied an analyst with immaterial information that permitted the analyst to complete a "mosaic" about the company? For how long after an officer makes an apparently immaterial selective disclosure of information must he or she consider whether price and volume movements call into question the accuracy of that judgment? And does the Commission expect an officer to *affirmatively* monitor price and volume movements subsequent to making a selective disclosure as a check on his or her decision that the information was not material, and will it assert that officers are reckless if they fail to do so?

III. Interpreting the SEC's Actions

We have described above some of the issues raised by the SEC's recent enforcement actions. We discuss these and others below.

First, the Commission has not developed consistent criteria for distinguishing intentional from non-intentional or inadvertent disclosure. In *Siebel Systems*, the Commission reached the conclusion that the company had selectively disclosed information *intentionally* by combining the CEO's knowledge that the information he had disclosed went beyond the prepared "talking points" of publicly available information with the DIR's separate understanding that the discussion at the analyst conference would not be broadcast publicly. In *Secure Computing*, in contrast, the Commission found that the CEO's first selective disclosure was *non-intentional* because, apparently, the CEO and the DIR had miscommunicated as to what information the CEO could disclose. In other words, in *Secure Computing*, the Commission did not combine the respective understandings of the company's senior officers to find a collective intent. Neither of the Commission's written Orders in the respective matters reconciles this inconsistency. (The Commission's finding of collective intent in *Siebel Systems* is itself noteworthy, as courts are in conflict as to whether the government can use the collective intent of several officers to establish improper intent on behalf of a company, or whether the government must prove that improper intent resided in the mind of any individual officer, whose improper intent then can be attributed to the company.)

Second, the Commission missed an opportunity in the *Secure Computing* matter to define the circumstances under which a company can cure a non-intentional selective disclosure through public dissemination of the information (and so avoid a Regulation FD violation). Although it found that the CEO's first selective disclosure was non-intentional, the Commission did not specify whether the company's subsequent public disclosure (at the close of the market the following day) was sufficiently timely to cure the violation.

Third, the SEC has not explained why it imposed a penalty in the *Siebel Systems*

matter but not in the *Raytheon* matter, leaving the reader to speculate that the difference came down to the evidence in *Siebel Systems* that the favored analysts at the conference actually used the selectively disclosed information and moved the market for Siebel Systems stock. Whatever the rationale, *Siebel Systems* suggests that, now that the Commission has issued this first group of Regulation FD cases, it will insist on significant monetary penalties in future matters. *Raytheon* and *Secure Computing*, of course, also demonstrate that the SEC will not be shy about naming individual company officers as secondary defendants in Regulation FD cases.

Finally, the Commission's limitation of the advice-of-counsel defense in *Motorola* will bear watching. If the Commission is true to its words, corporate officers will need to be particularly certain as to their course of conduct, even where counsel has advised that they may proceed. Similarly, corporations and their officers will need to be sensitive to whether the Commission will follow its hint in the footnote to the *Motorola* Order discussed above and impose a responsibility to monitor the marketplace for evidence of any impact of the putatively "immaterial" information such officers have selectively disclosed.

If you have any questions or require more information, please contact either of the authors of this White Paper:

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