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WSGR ALERT

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ENFORCEMENT ACTION SHOWS SEC WILL NOT TOLERATE ATTEMPTS TO CIRCUMVENT REGULATION FD

On October 21, 2010, the Securities and Exchange Commission (SEC) announced enforcement actions against Office Depot and two of its executives for violating Regulation Fair Disclosure (Regulation FD) by selectively communicating to analysts and institutional investors that the company would not meet analysts' earnings estimates. The enforcement actions were settled, with Office Depot agreeing to pay a $1 million penalty and each of the executives—the company's CEO and then-CFO—agreeing to pay $50,000. At the same time, Office Depot settled unrelated accounting claims.

The SEC's enforcement action charging violations of Regulation FD, the first in a little over a year, serves as a useful reminder that the SEC is determined to combat selective disclosure of material information and that it will not tolerate clever efforts to circumvent the rule. The SEC's announcement and related filings may be accessed at http://www.sec.gov/news/press/2010/2010-202.htm.

Regulation FD prohibits the selective disclosure of material information. Since the rule was adopted 10 years ago, the SEC has filed actions for violations of the rule ranging from explicit selective disclosure to analysts that their estimates were too high to less explicit instances where executives' tone and demeanor in private conversations with analysts conveyed material information not otherwise publicly disseminated.

The initial factual predicate of the case is not unusual. In June 2007, analyst estimates concerning Office Depot's anticipated second quarter performance were higher than the company's internal expectations. The company itself had not given specific guidance for the quarter, which was to end June 30, 2007.

The problem began, however, when Office Depot's CEO and then-CFO discussed how they might encourage analysts to lower their estimates and decided to contact analysts individually to achieve this result. The CFO then worked with the company's investor relations personnel to draft a detailed set of talking points to be used for private calls with analysts, which appear to have been designed to skirt Regulation FD's prohibition on selective disclosure.

On June 22 and 25, 2007, Office Depot's director of investor relations spoke individually with all 18 analysts covering the company and conveyed the talking points to them. During the calls, the company did not tell analysts directly that it would not meet expectations. Instead, following delivery of the talking points, the director singled out to analysts several companies that had experienced disappointing quarters due to the impact of the slowing economy on their businesses. In addition, analysts were reminded of Office Depot's earlier cautionary disclosures about the potential impact of a slowing economy.

It was not difficult for analysts to put the two concepts together and they promptly began to lower their estimates. Ultimately, 15 of the 18 analysts contacted lowered their estimates on Office Depot, reducing the consensus earnings-per-share estimate from $0.48 to $0.45.

The CEO and CFO did not personally participate in the calls and the CEO did not review the talking points, although he was apprised of how the initial calls had led to analysts lowering their estimates—and he urged the calls to continue so that additional analysts would lower their estimates. The SEC noted that Office Depot continued to make calls despite the CFO having been told that some analysts were expressing concerns about the lack of public disclosure of the information.

After the company had contacted the analysts, the CFO instructed the director of investor relations to contact the company's 20 largest institutional investors and relay the talking points to them. The director did so on June 26. The company announced after the close of market on June 28 that its earnings for the quarter would be "negatively impacted due to continued soft economic conditions."

Not surprisingly, the calls also led to a drop in the stock price before the June 28 announcement. Between the time the calls started to just before Office Depot issued its pre-announcement, the stock dropped 7.7 percent on substantially higher-than-average volume.

It is interesting that the SEC did not allege that the talking points that were conveyed to the analysts and institutional investors themselves contained any material nonpublic

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information. Nevertheless, the intent and effect of the communications to the analysts and investors was to convey highly material news—that Office Depot's earnings for the quarter would be below analyst expectations. Indeed, the SEC's adopting release issued when Regulation FD was first promulgated noted that a violation could occur even where the meaning was only implied. The SEC stated:

> 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 <u>through indirect "guidance," the meaning of which is apparent though implied</u>. (emphasis added)

Given the facts in the Office Depot case, the SEC had little difficulty arguing that this standard was met.

This enforcement action is a reminder that while the SEC does not pursue enforcement actions for violations of Regulation FD frequently, it is watching closely. More broadly, public companies and their executives should think twice about any attempt to "walk the street down."

The SEC's message seems to be clear: don't try to be clever to get around Regulation FD. To avoid this, issuers are well served to heighten their executives' understanding of Regulation FD and to implement appropriate policies and procedures to prevent violations.[1]

For more information or questions about the Office Depot enforcement action or any related matter, please contact a member of the firm's securities litigation practice.

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[1] The SEC noted that: "Office Depot did not have written Regulation FD policies or procedures at the time. The company had also never conducted any formal Regulation FD training prior to June 2007, although its general counsel had occasionally distributed guidance and updates on Regulation FD."

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