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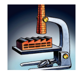

THE SEC'S REG FD

SOME LESSONS FOR PUBLIC COMPANY EXECUTIVES AFTER NINE YEARS OF PRACTICE

BY KARL A. GROSKAUFMANIS, STUART H. GELFOND AND JEFFREY M. FILIPINK

NINE YEARS AGO, the Securities and Exchange Commission broke new ground in adopting Regulation Fair Disclosure. This was the first time that the SEC directly regulated the informal contacts between public companies and investors, including one-on-one meetings, investor conferences and other communications outside formal SEC filings.

Reg FD prohibits public companies from disclosing material information to investors and analysts before the information is disseminated broadly in the marketplace. When material information is disclosed inadvertently, the Reg FD rules provide that this mistake can be cured by a prompt disclosure (typically within 24 hours).

Reg FD posed a different type of challenge for public company managers. While SEC filings can be refined through multiple drafts, Reg FD polices are unrehearsed communications that occur daily. The Reg FD cases the SEC has initiated over this first decade reflect a number of key lessons.

First, Reg FD places the principal legal risk in company-investor contacts on the source of the information—public company officers. Reg FD was adopted in part because selective disclosure fact patterns proved difficult to regulate as illegal insider trading. Rather than rely on that imprecise area of the law, Reg FD provides clearer codified rules for the SEC to enforce.

For example, in 2003, the SEC alleged that Schering-Plough Corp.'s CEO disclosed material, nonpublic information to institutional investors about disappointing quarterly results. The investors sold millions of Schering-Plough shares while aware of this information. In the end, Schering-Plough and the CEO settled SEC cases alleging Reg FD violations. None of the investors was charged.

Also, earnings guidance—management's estimate of operating results—must be transparent. It can be an estimated consolidated number (for example, earnings per share) or a key metric for the company (for example, same-store sales). Investors and analysts weigh management guidance in framing their own valuation of the company.

Changes—even subtle changes—in management guidance have been a fertile source of SEC enforcement actions. For example, the SEC sanctioned Raytheon Co. in 2002 for supplementing 2001 annual guidance to highlight that earnings would be skewed to the second half of the year (causing analysts to reduce their published first-quarter estimates). Since then, many companies have maintained a quiet period in the weeks before earnings announcements (in which they neither discuss operating results nor forecasts).

Management must also exercise care in confirming earnings guidance. After management provides guidance to the marketplace (typically when quarterly results are announced), investors will ask management whether they continue to believe (and confirm) the prior estimate. The concern is that, at some point in the fiscal quarter, confirming estimates communicates material information about operating results.

The SEC has been prepared to press this point. In its 2005 case targeting Flowserve Corp. and two of its officers, the commission alleged that a confirmation of earnings guidance 42 days before the end of the quarter amounted to a selective disclosure of material information.

Since the adoption of Reg FD, the SEC evaluates difficult materiality judgments with the benefit of hindsight. The SEC's materiality determinations have not been free from controversy. In 2005, a federal court dismissed an SEC Reg FD case against Siebel Systems Inc. principally because the commission did not allege facts sufficient to show that material information had been disclosed selectively.

Company managements must make materiality judgments in "real time" before they know precisely how the market will react to certain information. SEC enforcement actions are evaluated with the benefit of that precise information. This risk makes it prudent to be cautious in making materiality judgments.

Another key lesson from Reg FD: An inadvertent disclosure requires quick action. In its 2002 enforcement action against Secure Computing Corp., the commission alleged that the company's CEO compounded the error of an inadvertent disclosure by selectively disclosing information about a material contract before it was announced publicly. The Reg FD rules recognize that mistakes will be made. The challenge is that they must be cured quickly.

While much has changed since 2000, company-investor discussions remain a taut dance on a tightrope. There are critical business reasons to have these discussions. Reg FD enforcement creates a compelling need to exercise continuing care in these contacts. ■

Karl A. Groskaufmanis is a securities partner in the Washington office of Fried, Frank, Harris, Shriver & Jacobson LLP, Stuart H. Gelfond is corporate partner in the firm's New York office, and Jeffrey M. Filipink is a corporate associate in that office.

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