

# Regulation FD: The First Landmark Decisions

December 20, 2002

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On November 25, 2002, the SEC issued its first decisions under Regulation FD. The Commission issued three cease and desist orders and one Report of Investigation. Prior to their release, there was considerable publicity about at least two of the companies – Motorola and Raytheon – while the remaining two – Siebel Systems and Secure Computing – were not generally publicized. The following describes each fact-intensive case and then concludes by outlining the guidance that this first set of cases provides as to how the SEC interprets and will enforce Reg FD.

## 1. Raytheon<sup>1</sup>

On February 7, 2001, Raytheon conducted an investor conference where it reiterated annual earnings per share (“EPS”) guidance, but did not provide any quarterly EPS guidance. After the investor conference, the Chief Financial Officer, Franklyn A. Caine, directed his staff to contact each sell-side analyst whose estimates are included in Thomson Corporation’s First Call Service and request copies of the analysts’ quarterly model of Raytheon. Caine then arranged and conducted a one-on-one call with each analyst. Caine made these calls while knowing that Raytheon had not provided public quarterly earnings guidance for 2001, that the analysts’ first quarter 2001 EPS estimates generally exceeded Raytheon’s internal estimate and that the analysts’ 2001 quarterly earnings estimates reflected a less seasonal quarterly distribution than 2000 results.

Significantly, before Caine conducted these one-on-one conversations, analysts covering Raytheon attributed a general “seasonality” to Raytheon’s quarterly earnings pattern where the first quarter generally was the weakest and the fourth quarter generally was the strongest. According to this pattern, Raytheon produced earnings in an ascending slope where profits increase on a quarterly basis throughout the year. In 2000, the slope was steep in that Raytheon generated one-third of its earnings in the first half of the year. Prior to their one-on-one conversations with Cain, analysts projected that Raytheon’s 2001 earnings distribution would be more evenly distributed and less seasonal than in 2000. During these conversations with analysts, Caine communicated that in 2001 Raytheon’s earnings would likely have the same seasonal distribution as in 2000 and that Raytheon would generate one-third of its EPS in the first half of the year and the remaining two-thirds in the second half of the year. Caine also told certain analysts that their estimates for first quarter earnings or revenue for particular divisions were “too high,” “aggressive” or “very aggressive.” After the conversations, each analyst lowered his or her first and second quarter EPS estimates and increased

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<sup>1</sup> In the Matter of Raytheon Company, Securities Exchange Act of 1934 Release No. 46897 (Nov. 25, 2002), at <http://www.sec.gov/litigation/admin/34-46897.htm>.

EPS in the second half of the year. Subsequently, more than two million shares of Raytheon's stock was sold by one firm's sales force, whose analyst had received one of the on-on-one telephone call. The price of Raytheon's B stock fell approximately 6%, from \$32.80 to \$30.84, and the price of Raytheon's A Stock fell approximately 3%, from \$31.30 to \$30.50. Ultimately, Raytheon's selective disclosures enabled the company to beat the analysts' consensus 2001 first quarter EPS estimate by \$.01.

Raytheon was ordered by the SEC to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulation FD. Caine was also ordered to cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulations FD.

## **2. Secure Computing<sup>2</sup>**

In early 2002, Secure Computing Corporation entered into an original equipment agreement with one of the nation's largest computer networking companies (the "buyer") whereby Secure's product would be integrated into the buyer's product. Neither Secure nor the buyer made any public announcement of the deal. The agreement between the parties required that Secure receive the buyer's consent before Secure could announce the transaction. In early March 2002, Secure held an executive staff meeting, with Chief Executive Officer John McNulty participating via telephone, in which the executives expressed concern that the information regarding the agreement might leak to the public because the buyer's sales force was selling the product to beta customers. On March 6, at the buyer's request, Secure posted a page on its own website providing information and software downloads for the buyer's sales force and for customers who were evaluating the product. Secure's main website page did not reference the deal or provide a link to this web address. But as of March 6, 2002, McNulty knew that neither the buyer nor Secure had issued a public announcement of the agreement.

On March 6, McNulty conducted a conference call with a portfolio manager and a salesperson at a brokerage firm. McNulty and Secure's director of investor relations (the "IR Director") participated in the conference call. During this call, the IR Director mistakenly advised McNulty that he could disclose information about the agreement with the buyer to the portfolio manager and salesperson presumably because the information had been put on Secure's web page and was therefore public. McNulty's disclosure was the first time the salesperson from the brokerage firm had heard of the agreement. After the call, McNulty later confirmed to the managing partner of the brokerage firm the existence of the deal. Shortly thereafter, the IR Director informed McNulty that he had disclosed nonpublic information. McNulty telephoned the managing partner of the brokerage firm and requested that the information be kept confidential. That day, Secure did not make a general public announcement of the software agreement.

The next day, on March 7, Secure set out to try to obtain the consent of the buyer to make a public announcement but the buyer did not agree. McNulty also conducted conference call with four additional institutional investors during which McNulty confirmed that Secure had a deal with the buyer. That same day, Secure's stock price increased by 7% from the previous day on volume that

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<sup>2</sup> In the Matter of Secure Computing Corporation, Securities Exchange act of 1934 Release No. 46895 (Nov. 25, 2002), at <http://www.sec.gov/litigation/admin/34-46895.htm>.

was 130% higher. Following the close of the market, Secure eventually released the information regarding the agreement. In the days following the announcement, Secure's stock price continued to increase so that between March 5 and March 11, the stock price rose 35%. The SEC's Order states that although the March 6 disclosure of material and nonpublic information was not intentional, the March 7 disclosure was selective and violated Regulation FD because Secure and McNulty failed to make simultaneous public disclosure of the information to the public.

Secure Computing was ordered by the SEC to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulation FD. McNulty was also ordered to cease and desist from causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulations FD.

### **3. Siebel Systems<sup>3</sup>**

On November 5, 2001, the Chief Executive Officer of Siebel Systems, Inc. (the "CEO") made positive comments about the company's business and about the company's optimistic outlook because its business was returning to normal to the attendees of an invitation-only technology conference hosted by Goldman Sachs & Co. that was not web cast. These statements contrasted with public negative statements that the CEO had made about the company's business three weeks earlier in which he characterized the market for information technology as tough, and indicated that the company expected business to remain that way for the rest of the year. The company's investor relations staff knew, even if the CEO did not, that the conference would not be simultaneously broadcast to the public. On the day of the conference, the company's stock price closed 20% higher than the prior's day close and the trading volume was more than twice the average daily volume. There also appeared to some significance to the fact that Goldman Sachs provided Siebel with an advance list of the attendees of the technology conference and that the Goldman Sachs provided the company with a list of questions that the analyst planned to ask the CEO. Among the questions was whether the company had "any evidence that the software market [was] getting any better or worse."

Siebel was ordered by the SEC to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulation FD. Siebel also agreed to pay a \$250,000 civil penalty, without admitting or denying the SEC's allegations.

### **4. Motorola<sup>4</sup>**

The SEC has investigated whether the director of investment relations at Motorola, Inc. (the "IR Director") selectively disclosed information about the company's quarterly sales and orders during private telephone calls with sell-side analysts in March 2001, but did not commence a formal enforcement action. Previously, in a February 23, 2001 press release and public conference call, Motorola disclosed only that sales and orders were experiencing "significant weaknesses" and that

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<sup>3</sup> [In the Matter of Siebel Systems, Inc.](http://www.sec.gov/litigation/admin/34-46896.htm), Securities Exchange Act of 1934 Release No. 46896 (Nov. 25, 2002) at <http://www.sec.gov/litigation/admin/34-46896.htm>.

<sup>4</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934; Motorola, Inc., Securities Exchange Act of 1934 Release No. 46898 (Nov. 25, 2002), at <http://www.sec.gov/litigation.investreport/34-46898.htm>.

Motorola was likely to miss its earnings estimates for the quarter and have an operating loss for the quarter if the order pattern continued. Following this announcement, most analysts lowered their estimates. Nevertheless, after reviewing the analysts' models and research notes, the IR Director concluded that the analysts still were overstating Motorola's likely quarterly results. Therefore, between March 6 and March 12, 2002, the IR Director directly contacted approximately 15 analysts to discuss their models. On at least ten of these calls, the IR Director told analysts that when Motorola uses the terms "significant" or "significantly" it intends a rate of change of 25% or more. All of the analysts directly contacted directly by the IR Director revised their models following the calls.

Before making the phone calls, the IR Director sought and obtained the advice of Motorola's in-house legal counsel responsible for SEC reporting and disclosure issues. Counsel specifically advised the IR Director that he could contact selected analysts, reiterate the information that had been disclosed previously and provide quantitative definitions for certain qualitative terms. Counsel based that legal advice on the conclusion that providing a quantitative definition for the term "significant" was not material. Counsel also concluded that Motorola's particular definition of the word was public for Regulation FD purposes.

The SEC made the following observation about this case:

- The information selectively disclosed by Motorola clearly was material;
- Senior officials of issuers should be particularly cautious during private conversations with analysts;
- After-the-fact private communications of material, non-public information to securities professionals are not a proper way to supplement a prior public disclosure that the issuer determines to have been misunderstood or misinterpreted;
- When communicating with securities industry professionals, issuers may not use "code" words to selectively disclose information that they could not selectively disclose expressly; and
- In issuing the report rather than commencing a formal enforcement action, the SEC credited Motorola's reliance on counsel in the context of the case concerning Regulation FD issues because the legal advice was sought and given in good faith (the SEC also cautioned that reliance on counsel will not necessarily provide a successful defense in all future cases and that availability of any reliance on counsel argument turns on all the facts and circumstances of the case).

## **5. The Teachings of the November 2002 Reg FD Cases**

Each of the decisions is very fact intensive but they do provide very helpful guidance. The takeaways are:

- First and foremost, it is clear that materiality will be judged in hindsight. In each decision, the SEC based its materiality determination upon what the recipients of the information did after receiving it and the effect on the price and volume of the issuer's

stock following the private disclosure (especially Siebel where the materiality issue was a close call).

- These cases are easy for the SEC to prepare: the phone calls to analysts are documented by time and in one instance by a transcript and the market reaction and actions taken by the analysts after the calls are also easily documented.
- The SEC has reemphasized that it considers earning guidance to be problematic (Motorola and Raytheon).
- Purposely seeking out analysts in one-on-one calls to correct information that may have been misunderstood is extremely dangerous. The method to correct previously disclosed misunderstood information is not through selective calls but a general public release (Motorola and Raytheon).
- Avoid “code words” – “significant” means 25% (Motorola).
- Reliance on counsel’s advice will probably not prevail in the future and, more importantly, the SEC expressly noted in Motorola that an issuer’s chief financial officer or investment officer may not be able to rely on counsel’s advice since they may have a “keener awareness than company counsel of the significance of information to investors.”
- Monitoring market action after a private disclosure can help a company determine whether the information disclosed was material; if the market reacts, it’s more likely that the information was material and an immediate public release should be considered. This avoids a Regulation FD violation (Secure Computing). In fact, the SEC in Secure Computing noted that the initial selective disclosure did not violate Regulation FD (presumably because the information was thought to be public) and had Secure Computing immediately disclosed the information publicly, a Regulation FD would not have occurred. Unfortunately for Secure, its officers continued to make selective disclosures before making a public announcement.
- As reflected by Secure Computing, confidential business transactions can cause serious FD problems. Secure clearly had a dilemma because it was under a contractual restriction prohibiting disclosure and yet because of the beta testing it had to post certain sensitive information on its web site. In the future, care should be taken when negotiating similar contractual relations to permit public disclosure if required by Regulation FD or some other alternative should be contractually adopted. Note also that non prominent web site disclosure may not satisfy Regulation FD.
- Non-web casted analyst conferences can be dangerous (Siebel) especially when the company knows who will be present and the questions to be asked.
- Soft business information can be material – “the Company was optimistic because its business was returning to the normal” in contrast to public negative statements made three weeks earlier (Siebel). Note that immediately prior to the conference (without the knowledge of Siebel but after a private discussion with Siebel’s CFO and IR Director), the analyst in charge of the conference circulated for internal use only a memo indicating that the Siebel CEO may set a “positive tone ... it seems as if business activity has

increased.” The SEC also goes to pains to demonstrate that the CEO’s personal knowledge was based on internal non-public information concerning the Company’s sales pipeline. According to the SEC, “the disclosures were based on non public information that was internal to and reflected trends in the Company’s business.” The talking points provided to Siebel’s CEO were carefully crafted to include only publicly available information. For some unexplained reason, however, the CEO deviated and announced the “good news” in contrast to his previous negative statements.

- In projecting a full year’s business, the Company was providing material information and not mosaic information (Raytheon).

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