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SEC ENFORCEMENT ACTIONS UNDER REGULATION FD

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Approximately two years after its adoption, on November 25, 2002 the Securities and Exchange Commission (the "SEC") filed its first enforcement actions under Regulation FD.[1] The SEC issued cease-and-desist orders (the "Orders") against three companies and two officers. Each Order found that the company and the named officials violated Section 13(a) of the Exchange Act and Regulation FD and ordered the company and named officials to cease and desist from committing or causing violations of these provisions. All three proceedings were settled by the companies without admitting or denying the SEC's findings. As to one company, the SEC also filed a civil action in federal court to obtain an agreed upon civil penalty of $250,000. Finally, the SEC also filed a report of investigation against one company that it did not otherwise sanction ("21(a) Report").[2]

Under Regulation FD, whenever an issuer, or person acting on an issuer's behalf, intentionally discloses material nonpublic information to securities market professionals or holders of the issuer's securities who may trade on the basis of the information, the issuer must make simultaneous public disclosure of that information. If the issuer unintentionally discloses material information, it must "promptly" make public disclosure of such information.[3]

Consistent with statements the SEC has made since the adoption of Regulation FD, the SEC chose to bring enforcement actions only in cases that presented clear violations of the

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1 See In the Matter of Siebel Systems, Inc., Administrative Proceedings File No. 3-10949 and Securities Exchange Act of 1934 Release No. 46896; Securities and Exchange Commission v. Siebel Systems, Inc., Litigation Release No. 17860; In the Matter of Secure Computing Corporation and John McNulty, Administrative Proceeding File No. 3-10948 and Securities Exchange Act of 1934 Release No. 46895; and In the Matter of Raytheon Company and Franklyn A. Caine, Administrative Proceeding File No. 3-10950 and Securities Exchange Act of 1934 Release No. 46897.

2 See 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.

3 For a more detailed description of Regulation FD see our memorandum dated August 24, 2000 entitled "*New SEC Rules on Selective Disclosure and Insider Trading,*" which is available upon request or at our website: *www.simpsonthacher.com*.

regulation, using the Motorola 21(a) Report to discuss a violation that many will view as being more in a gray area. The following is a summary of the facts as found by the SEC surrounding each company's violations of Regulation FD and of the facts discussed in the 21(a) Report:

SIEBEL SYSTEMS, INC.

In November 2001 the Chief Executive Officer ("CEO") of Siebel Systems, Inc. ("Siebel") participated in a technology conference hosted by Goldman Sachs & Co. The conference was not "FD compliant." Admission was by invitation only and the remarks made were not simultaneously publicly disseminated. The attendees at the conference included broker-dealers, investment advisers and investment companies, including large institutional holders of Siebel's stock.

In response to questions from an analyst, the CEO disclosed that Siebel was optimistic about its future prospects because its business was returning to normal. Specifically the CEO stated that the company was "pretty optimistic" because it was witnessing "a return to normal behavior in IT buying patterns" and because "the linearity of this Q4 will be about what we saw in Q4 of the previous two years." These statements contrasted sharply with negative statements that the CEO had made in a publicly disseminated conference call three weeks earlier. In the public call, the CEO characterized the market for information technology as "tough," and indicated that the company expected the market would remain that way for the balance of the year.

Siebel's Investor Relations Director was aware that the Goldman Sachs conference would not be webcast but failed to inform the CEO of this fact. Immediately following the disclosures, certain attendees at the conference purchased Siebel stock or communicated the disclosures to others who purchased its stock. On the day of the conference, Siebel's stock price closed approximately 20% higher that the prior day's close on volume approximately double Siebel's normal trading volume.

In addition to the SEC's cease-and-desist order, the SEC also filed a civil action against the company to obtain a $250,000 civil penalty. Two commissioners dissented from the decision to impose a civil fine on Siebel.

In entering the cease and desist order against Siebel, the SEC relied, at least in part, on the fact that at least some attendees at the conference immediately traded on the information and communicated the information to others as evidence of the materiality of the information. Additionally, the SEC found the company liable for a violation of Regulation FD based on the fact that the Director of Investor Relations knew the conference would not be FD compliant, even through the speaker himself was unaware of that fact.

SECURE COMPUTING CORPORATION

In early 2002, Secure Computing Corp. ("Secure"), a software company, entered into an original equipment manufacturing ("OEM") agreement with one of the nation's largest computer networking companies (the "buyer"). Neither the buyer nor Secure made any public announcement of the arrangement. On March 6, at the buyer's request, Secure posted a page on its website providing information and software downloads for the buyer's salesforce and customers who were evaluating Secure's product. Secure's main website page did not reference the deal or provide a link to this web page address.

Also on March 6, 2002, John McNulty, the CEO of Secure, conducted a conference call with a portfolio manager at an investment advisory firm. A salesperson at a brokerage firm that follows Secure and Secure's Investor Relations Director were also on the call. The call was not FD compliant because it was not publicly accessible. During the call McNulty asked the Investor Relations Director if he could discuss something that had been posted on the company's website. The Investor Relations Director, unaware that McNulty was referring to the OEM agreement, confirmed that he could. As McNulty selectively disclosed the existence of the OEM agreement, the Investor Relations Director recognized that the agreement had not been publicly announced and that McNulty should not be discussing the subject in a non-public call. She did not, however, interrupt McNulty. After the call the Investor Relations Director left McNulty a voice mail informing him that he had disclosed nonpublic information on the conference call. Although McNulty subsequently asked the managing director of the brokerage firm that had been on the call to keep the information confidential, the company made no public disclosure of the OEM agreement.

On the morning of March 7, trading volume in Secure's stock rose significantly, and Secure received several calls from investors and analysts indicating there were rumors about the OEM agreement. That same day, during a conference call with a portfolio manager of another institutional advisory firm, McNulty confirmed Secure had a deal with the buyer and told the advisor that the deal had not yet been publicly announced. Secure finally publicly announced the contract in a press release issued on March 7 after the close of the stock markets. On March 6, the share price rose 8% on approximately double its normal trading volume. On March 7, the share price rose an additional 7% on volume that was 130% higher than normal. Following the public announcement, the stock rose another 7%, again with high volume.

In entering the cease and desist order, the SEC found that the selective disclosure on March 6 was non-intentional and that Secure and McNulty did not, as required by Regulation FD, make prompt public disclosure of the information that had been selectively disclosed. McNulty and Secure further violated Regulation FD by intentionally selectively disclosing the same information on March 7.

As to Secure and McNulty, the SEC entered a cease and desist order, but did not impose a fine, over the dissent of one commissioner.

RAYTHEON COMPANY

On February 7, 2001, Raytheon Company ("Raytheon") conducted an investor conference that was FD compliant as it was publicly webcast. During the conference Franklyn Caine, the CFO of Raytheon, reiterated annual earnings per share ("EPS") guidance but did not provide any quarterly guidance. After the conference, Caine obtained copies of reports of all sell-side analysts whose estimates are included in Thomson Corporation's First Call Service. Caine then arranged one-on-one calls with each analyst. During those calls Caine provided substantially the same non-public earnings information to each analyst: that in 2001 Raytheon's earnings would likely have the same seasonal distribution as 2000, specifically, that Raytheon expected it would generate one-third of 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 their estimates for quarterly earnings or revenue for particular divisions were "too high," "aggressive," or "very aggressive." After their conversations with Caine, each of the analysts reduced their quarterly earnings estimates in amounts ranging from $0.01 to $0.10. Those changes reduced the analysts' estimates to below or right at Raytheon's own internal estimates of its first quarter results. In addition to lowering their first quarter estimates, two analysts announced the reduction in calls to their firm's sales forces. Following one analyst's call discussing the reduced estimate, the firm's sales force sent e-mails to institutional clients regarding the morning call saying "RTN has problems in qtr, stock at risk." That day the price of Raytheon's B stock fell approximately 6%.

In issuing cease and desist orders against Raytheon and Caine, the SEC specifically disclaimed reliance on the price decline on Raytheon's stock on March 1 in finding the selective disclosures were of material information. Instead, it pointed to five facts as evidence of materiality: (1) the information was earnings guidance, a topic the SEC specified when it adopted Regulation FD is likely to be material; (2) Caine reached out to numerous analysts and delivered to each the same message; (3) the analysts reacted consistently to lower their earnings guidance after learning the information; (4) two analysts announced the reduction in their estimates to their firm's sales force; and (5) one analyst sent an e-mail to the firm's sales force highlighting the reduced estimate.

As with Secure, one commissioner dissented from the decision not to impose a fine.

MOTOROLA, INC.

In a February 23, 2001 press release and an FD-compliant conference call, Motorola, Inc. ("Motorola") disclosed that sales and orders were experiencing "significant weakness" and that Motorola was likely to miss its earnings estimates of 12 cents per share for the quarter and have an operating loss for the quarter if the order pattern continued. Although analysts who follow Motorola lowered their estimates after the February 23 call, many did not lower them as far as Motorola would have liked. After consulting with counsel, the Director of Investor Relations called approximately 15 analysts to discuss their estimates. Essentially, the Director told each analyst that when Motorola said "significant" it meant "25% or more." All of the analysts reduced their estimates further following the one-on-one calls. Motorola specifically decided not to issue a new press release or otherwise make any public disclosure of this information (i.e., that "significant" means "25% or more").

The SEC did not bring an enforcement action against Motorola finding that the company relied on erroneous but good faith legal advice that the information being selectively disclosed was not material and was already public. Instead, it used Motorola's conduct to provide further guidance about Regulation FD, how it should be applied and suggestions about how it will be enforced in the future.

First, the SEC noted that the information selectively disclosed by Motorola was clearly material. "Counsel testified that the term significant means 'very large,' which, in counsel's view, was no different from saying '25% or more.' … The fact that the IR Director believed it necessary to call analysts to guide them to a '25% or more' conclusion demonstrates that, regardless of what Motorola originally intended to convey by the term 'significant weakness,' the IR Director subsequently discovered that it had not been understood to mean '25% or more.'"

Next, the SEC used the Motorola facts to remind senior officials of issuers that they should be particularly careful during non-public conversations with analysts, particularly if the conversations involve discussion of corporate earnings. Additionally, such non-public discussions are not the appropriate way to supplement a prior public disclosure, particularly one that by all indications has not been correctly understood. Rather, the appropriate way to correct the situation is to make additional public disclosure.

Finally, the SEC also noted that it is not appropriate for issuers to use "code words" to make selective disclosure of information that they know they could not make expressly. In the case of Motorola, the SEC suggested that the use of the term "significant" was a code word intended to convey to analysts a reduction in sales of 25% or more – a specific quantitative meaning that the general investing public would not likely draw from the word. The SEC found particularly troubling the fact that Motorola, having realized that analysts did not understand the quantitative aspects of the code word used, "engaged in private discussions with analysts to provide a more detailed quantitative definition."

OBSERVATIONS

The SEC's early guidance with respect to Regulation FD was that enforcement action would only be instituted in cases of clear violations and that "issuers will not be second-guessed on close materiality judgments." While reasonable minds may differ on whether Motorola was making a close materiality judgment, it is somewhat encouraging that the subject matters at issue in these cases are matters that are generally acknowledged by all issuers to be potentially material to investors: earnings guidance and significant new contracts. Moreover, these are subject matters that the SEC highlighted in the adopting release for Regulation FD as areas to be reviewed carefully by issuers prior to being selectively disclosed. The release stated that private discussions between an issuer and an analyst seeking guidance about earnings estimates entail a "high degree of risk under Regulation FD."

It is also encouraging that the SEC's actions were measured. The SEC imposed a small fine on only one of the companies[4] and did not proceed at all against Motorola based on its reliance on advice of counsel.

While those aspects of these cases are encouraging, there are also warnings for issuers contained in the Motorola 21(a) Report. Specifically, although the SEC excused Motorola's violation based on its reliance on legal advice, it also noted that:

> "[r]eliance on counsel will not necessarily provide a successful defense in all future cases… [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. … Finally, … we also note that … we would be less likely in future cases to credit reliance on counsel for the advice rendered here."

Regulation FD has largely been incorporated into the fabric of issuers' relationships with analysts and institutional investors. Nevertheless, these cases serve as a timely reminder of certain basic principles:

- Whenever officials covered by Regulation FD speak at events attended by securities market professionals at which questions may be asked that may elicit material non-public information, the officials must know whether the event is FD compliant and have a good knowledge of what has and has not been publicly disclosed. If the event is not FD compliant, the officials should be instructed that they must confine their presentations to public information. If there is a concern that officers may not be able to do so, then the company should not participate in the event unless it is open to the public.

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[4] The SEC did not explain why Siebel was fined but Raytheon and Secure were not. Factors that may have influenced that decision include the fact that it was the CEO who made the selective disclosure, the information selectively disclosed was dramatically different from the information the company had publicly disseminated recently, the information was selectively disclosed to a group highly likely to act on it (to the detriment of shareholders not privy to the information) and there was a dramatic and immediate price rise following the selective disclosure. In contrast, in Raytheon, the selectively disclosed information was consistent with, although more exact, than the publicly disclosed information. On the other hand, in Secure the information was new and the company essentially violated Regulation FD twice – first by not promptly publicly disclosing information that has been non-intentionally selectively disclosed and then by intentionally selectively disclosing the same information. In short, one cannot determine from this small sample of cases when the SEC will seek a fine or whether the obvious disagreement within the SEC will continue to keep any fines that are imposed fairly low.

- Investor relations personnel must have comprehensive training with respect to the requirements of Regulation FD. It is imperative that these personnel actively oversee and coordinate company communications to securities market professionals and shareholders. In addition, covered officials who have contact with the financial community may require periodic reminders concerning Regulation FD's requirements. Counsel should be consulted whenever questions arise. Although the Motorola 21(a) Report makes clear that advice of counsel is not an absolute defense, it is certainly evidence that can be helpful to an issuer should the SEC enforcement staff question its compliance with Regulation FD.

- Although one-on-one discussions with analysts are not prohibited by Regulation FD, issuers must approach such conversations very cautiously. Issuers must carefully consider what types of interaction they wish to have with analysts outside of FD compliant analysts' meetings or conference calls. Contact that is not FD compliant that is designed to "walk the street" up or down is likely to violate Regulation FD and should be avoided. To the extent analysts' estimates are not in line with a an issuer's internal estimates – and the issuer believes it is important to get the estimates more in line – the safest course of action is to publicly disclose the information that will lead the analysts to more accurate predictions.

- Whenever material non-public information is disclosed in a selective manner, the issuer must immediately take steps in order to make public disclosure of that information.

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This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, *www.simpsonthacher.com*.

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