

SEC Continues to Prosecute Regulation Fair Disclosure Violations

Office Depot and Two Senior Executives Charged With Improper “Wink and Nod” Disclosures to Analysts

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The Securities and Exchange Commission recently settled enforcement actions against Office Depot, Inc. and two of its former top executives for violating or causing violations of Regulation Fair Disclosure (“Regulation FD”).¹ According to the SEC, Office Depot, and its then CEO and CFO, selectively signaled to analysts and institutional investors that the company would not meet analysts’ earnings estimates for the second quarter of 2007. These selective disclosures began nearly one week before the company publicly disclosed negative sales and earnings information and were accomplished through a “wink and nod” type of approach, rather than direct statements about the company itself. Indeed, according to the SEC’s allegations, Office Depot did not directly state that it would not meet analysts’ estimates, but rather made references to recent public statements of comparable companies regarding the impact of the slowing economy on their earnings, and reminded analysts about its own cautionary public statements earlier in the year. These calls, which were allegedly designed to encourage analysts to revise their estimates downward, had their desired effect – analysts promptly lowered their quarterly estimates.

To resolve these charges, and without admitting or denying the SEC’s allegations and/or findings, Office Depot agreed to pay a \$1 million civil penalty, while the two executives each agreed to pay penalties of \$50,000.² SEC Enforcement Director, Robert Khuzami, stated that the conduct of the Office Depot executives, in an effort to manage earnings expectations, provided an “illegal” and “unfair advantage to favored investors at the expense of other investors.” Such comments, coupled with the filing of these and other relatively recent enforcement actions, clearly signal the SEC’s continued interest in vigorously prosecuting violations of Regulation FD.

Overview of Regulation FD

Regulation FD essentially requires that, when issuers disclose material nonpublic information, they must make broad public disclosure of that information. More specifically, it prohibits issuers from disclosing material nonpublic information to certain enumerated persons (*e.g.*, securities analysts and institutional investors) without disclosing that information to the public. Under Regulation FD, if the selective disclosure is “non-intentional,” issuers must publicly disclose the information *promptly* after a senior official learns of the disclosure; and if the selective disclosure is “intentional,” issuers must *simultaneously* make a public disclosure.³ The failure by an issuer to make these required public disclosures constitutes a violation of Regulation FD as well as Section 13(a) of the Securities Exchange Act of 1934.

Since Regulation FD's adoption in August 2000, the SEC's Division of Corporate Finance has provided several interpretations concerning Regulation FD. In these interpretations, the SEC has stated that "a confirmation of expected quarterly earnings made near the end of a quarter might convey information about how the issuer actually performed" and that "the inference a reasonable investor may draw from such confirmation may differ significantly from the inference he or she may have drawn from the original forecast early in the quarter."⁴ Significantly, although the issuer can confirm a forecast that it has previously made to the public without triggering Regulation FD's public reporting requirement, the issuer should "consider whether the confirmation conveys any information above and beyond the original forecast and whether that additional information is itself material" (when assessing the materiality of the forecast confirmation). An issuer may, however, provide material nonpublic information to analysts if the analysts expressly agree to maintain the confidentiality until the information is public.⁵

Office Depot – Allegations and Settlements

The SEC charged Office Depot with violating Regulation FD and Section 13(a) of the Exchange Act in both a settled administrative and a settled federal district court action.⁶ Simultaneously, the SEC also filed settled administrative proceedings against the individuals who served as Office Depot's CEO and CFO at the time of these violations. The basic allegations underlying these enforcement actions are outlined below.

In the second quarter of 2007, Office Depot faced the likelihood of not meeting analysts' market expectations. In this vein, the SEC alleged that the CEO informed the board of directors and executive committee at the end of May 2007 that the company would not likely meet analysts' consensus \$0.48 earnings per share estimate and that senior management was discussing a strategy for advance communication to avoid completely surprising the market. By mid-June 2007, the company's preliminary internal estimates forecasted for the quarter were \$0.04 lower than analysts' consensus estimate according to the SEC.

Against this backdrop, and 10 days before the quarter's close, Office Depot's CEO and CFO allegedly discussed how the company might encourage analysts to revisit their analysis of the company and lower their estimates. To accomplish this, according to the SEC, the CEO suggested that the company talk to analysts and refer them to recent earnings announcements by two comparable companies that had publicly announced results that were impacted by the slowing economy and highlight to analysts certain elements of what Office Depot had previously disclosed to the market in April and May 2007 (*e.g.*, warning investors that its largest business segments faced a softening demand that was continuing into the second quarter). After the CEO and CFO adopted this "wink and nod" type of approach, a series of talking points – based in part on the CEO's suggestions – were allegedly drafted by certain persons at the company, including the CFO, as a guide for the calls to analysts.

Thereafter, on two separate days before the end of the quarter, a series of one-on-one calls were allegedly made to 18 analysts covering the company. Specifically, the SEC claimed that Office Depot's director of investor relations spoke individually with each analyst and provided them with the "talking points" information. The CEO and CFO allegedly communicated with the director of investor relations both during and after such calls. Further, the SEC claimed that many analysts were influenced by these calls and lowered their second quarter 2007 forecasts. Indeed, by the second day of calls, 15 of the analysts had allegedly lowered their estimates, thereby bringing the consensus estimate down from \$0.48 to \$0.45.

According to the SEC, two of the analysts contacted by Office Depot allegedly expressed concern or surprise that the company had not issued a press release – one even indicating that several of his clients were surprised at the lack of a press release. Interestingly, after receiving this information, the CFO

allegedly instructed the director of investor relations to call the company's top 20 institutional investors and convey to them the talking points information.

Six days after the calls to the analysts commenced, Office Depot filed a Form 8-K after the market closed. This public filing disclosed, among other things, that the company's earnings would be "negatively impacted due to continued soft economic conditions." Moreover, the company's stock dropped 7.7% between the day Office Depot began calling analysts and the last market close before it filed its Form 8-K.

For their roles in the conduct described above, Office Depot's then CEO and CFO agreed to cease and desist from causing any violations or future violations of Regulation FD and Section 13(a) of the Exchange Act and to pay a \$50,000 civil penalty. Further, Office Depot agreed to cease and desist from committing or causing these same violations and consented to the entry of a final judgment requiring payment of a \$1 million civil penalty. Significantly, in each of these actions, the SEC noted that Office Depot did not have written policies or procedures concerning Regulation FD and had not conducted any formal training in this area.

Other Recent Regulation FD Matters

The *Office Depot* action reflects the SEC's recent heightened enforcement of Regulation FD violations. Since September 2009, the SEC has brought two other cases alleging violations of Regulation FD. Similar to *Office Depot*, both of these cases also involved allegations concerning the selective disclosure of a company's financial performance.

In September 2009, the SEC filed a civil injunctive action against Christopher A. Black, the former CFO of American Commercial Lines, Inc., for aiding and abetting the company's violation of Regulation FD.⁷ The SEC alleged, among other things, that the former CFO, while acting in his capacity as the company's designated investor relations contact and without informing anyone at the company, selectively disclosed material nonpublic information regarding the company's second quarter 2007 earnings forecast to a limited number of analysts. The SEC further alleged that the selective disclosures and resulting analysts' reports triggered a significant drop in the company's stock price. In settling with the SEC, the former CFO agreed to pay a \$25,000 civil penalty and to a cease-and-desist order. Significantly, however, the SEC determined not to bring an enforcement action against the company because it self-reported the violation and provided extraordinary cooperation to the SEC staff.⁸

In March 2010, the SEC filed a civil injunctive action against Presstek, Inc. and its former CEO alleging Regulation FD violations for the selective disclosure of material nonpublic information regarding the company's financial performance to a managing partner of a registered investment adviser.⁹ This partner then allegedly decided, within minutes after receiving this information, to sell all of the Presstek stock managed by the investment adviser. Significantly, in settling this matter with Presstek for a \$400,000 civil penalty, the SEC considered certain remedial measures taken by the company, including the revision of its corporate communications policies and corporate governance principles, the replacement of its management team, and the appointment of new independent board members.¹⁰

Conclusion

In light of *Office Depot*, and the other relatively recent enforcement actions discussed above, the SEC clearly plans to continue its pursuit and prosecution of Regulation FD violations. It is, therefore, critical for issuers to establish and maintain stringent policies and procedures to prevent any such violations.¹¹ Formal and periodic training is also clearly viewed by the SEC as an important element to an effective Regulation FD compliance program and will provide further evidence that a company takes this area of the law very seriously. Finally, as demonstrated by *Presstek* and *Black*, the SEC continues to promote quick remedial measures and cooperation for those companies facing a potential action.



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- ¹ See Press Release, *SEC Charges Office Depot and Company Executives With Improper Disclosures to Analysts* (Oct. 21, 2010), available at <http://www.sec.gov/news/press/2010/2010-202.htm> ; *SEC v. Office Depot, Inc.*, Civ. Act. No. 9:10-cv-81239 (S.D. Fla.), Lit. Rel. No. 21703 (Oct. 21, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21703.htm>.
- ² See *In re Office Depot, Inc.*, Exchange Act Rel. No. 63152 (Oct. 21, 2010); *In re Stephen A. Odland*, Exchange Act Rel. No. 63153 (Oct. 21, 2010); *In re Patricia A. McKay, CPA*, Exchange Act Rel. No. 63154 (Oct. 21, 2010).
- ³ The term *promptly* means "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange)." And, *intentional* means "when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic."
- ⁴ See Regulation FD, Division of Corporate Finance, *Compliance and Disclosure Interpretations* (June 4, 2010), available at <http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm>.
- ⁵ *Id.*
- ⁶ Unrelated to the Regulation FD violations, the SEC also charged Office Depot in these actions with overstating its net earnings in its financial statements for the third quarter of 2006 through the second quarter of 2007 (as a result of accounting violations). *SEC v. Office Depot, Inc.*, Lit. Rel. No. 21703 (Oct. 21, 2010).
- ⁷ See *SEC v. Christopher A. Black*, Case No. 09-CV-0128 (S.D. Ind.), Lit. Rel. No. 21222 (Sept. 24, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21222.htm>.
- ⁸ Specifically, reasons for which the SEC determined not to bring an enforcement action against the issuer included that the SEC found that the issuer cultivated an environment of compliance by providing Regulation FD training and adopted policies to prevent future violations, and promptly filed a Form 8-K after learning about the illegal disclosure. The SEC also found that the former CFO was solely responsible for the violation and that he had acted outside of the company's control system, which was established to prevent improper disclosures.
- ⁹ See *SEC v. Presstek, Inc.*, 1:10-CV-10406 (D. Mass.), Lit. Rel. No. 21443 (Mar. 9, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21443.htm>.
- ¹⁰ The SEC is seeking injunctive relief and civil penalties in its ongoing action against the company's former CEO. *Id.*
- ¹¹ For example, the National Investor Relations Institute's sample corporate disclosure policy imposes a quiet period that runs from a date near the end of the quarter until earnings results are publicly released. During this period, the company would not discuss current business performance or results of operations.