

Implied Signals: A Regulation FD Violation Alert

On October 21, 2010, the SEC settled enforcement actions against Office Depot, its Chief Executive Officer, and its former Chief Financial Officer for alleged Regulation FD violations for selectively providing “signals” to analysts and institutional investors during one-on-one conversations that Office Depot would not meet analysts’ earnings estimates. The challenged statements did not explicitly disclose any material nonpublic information but packaged public information in a way allegedly designed to indicate that Office Depot would not meet the earnings estimates.

Communications in Question

Consensus estimates for Office Depot’s second quarter were higher than internal forecasts. Office Depot’s CEO and former CFO scripted and initiated one-on-one phone calls late in the quarter with all 18 analysts covering the company and multiple institutional stockholders, allegedly for the purpose of encouraging them to lower earnings expectations for the quarter. The approved talking points at issue included:

- “At beg. of Qtr we’ve talked about a number of head winds that we were facing this quarter including a softening economy, especially at small end.
- I think the earnings release we have seen from the likes of [Company A], [Company B], and [Company C] have been interesting.
- On a sequential basis, [Company A] and [Company B] domestic comps were down substantially over prior quarters.
- [Company C] mentioned economic conditions as a reason for their slowed growth.
- Some have pointed to better conditions in the second half of the year—however who knows?
- Remind you that economic model contemplates stable economic conditions – that is mid-teens growth.”

Following the calls, 15 of the 18 analysts contacted lowered their earnings estimates. Office Depot’s stock price dropped on increased trading volume. Six days after initiating the calls to the analysts, Office Depot filed a Form 8-K, which announced to the market that its sales and earnings would be negatively affected by the continued soft economy.

The SEC’s View

Although Office Depot did not explicitly tell analysts that it would not meet expectations, the SEC charged the company with selective sharing of material inside information by providing orchestrated implied signals to analysts during private discussions designed to lead them to that conclusion. Facts that led the SEC to claim that Office Depot had run afoul of Regulation FD included:

- The CEO and CFO discussed how to encourage analysts to revisit their analyses of the company.
- Office Depot did not regularly initiate these types of calls to all of its analysts.
- The calls were planned by, and made at the direction of, the CEO and CFO.

- Analysts complained about the lack of public disclosure on the topic, which was reported to the CFO, suggesting the need for corrective disclosure.
- Fifteen of 18 analysts did, in fact, lower their earnings estimates.
- Office Depot's stock price dropped 7.7% between the calls and the filing of the Form 8-K.
- Office Depot had no written Regulation FD policies or procedures in place at the time and had never conducted formal Regulation FD training, although its General Counsel had occasionally distributed guidance and updates on Regulation FD.
- The statements were made at the end of the quarter when substantial real data was known.

Office Depot agreed to settle the SEC's Regulation FD charges without admitting or denying the findings and allegations and agreed to pay a \$1 million penalty. Office Depot's CEO and CFO settled the charges against them without admitting or denying the findings, and each agreed to pay a \$50,000 penalty.

Important Reminders

These actions are a good reminder that Regulation FD covers all types of selective communication of material inside information. The SEC originally adopted Regulation FD in response to concerns about selective "guidance" and "talking down" of analysts and significant investors to the disadvantage of the general public. The SEC has been clear in its views that Regulation FD covers both express and indirect material communications, the meaning of which is apparent though implied, and can't be circumvented by ostensibly breaking communication into non-material pieces.

Note, however, that some communications, even in one-on-one contexts, may be so vague as to be immaterial. By way of example, the Southern District of New York dismissed the SEC's case in *Securities and Exchange Commission v Siebel Systems, Inc.*, S.D.N.Y., No. 04CV5130 (GBD), September 1, 2005, where vague expressions of optimism that caused institutional investors attending a one-on-one meeting and an invitation-only dinner to purchase shares were held not to be material and not violations of FD. Thus, the fact that the analysts changed their estimates in this case does not in and of itself establish materiality and thus provide a basis for a Regulation FD violation.

Private discussions with analysts and significant investors, especially late in reporting periods, should be carefully considered from a Regulation FD perspective.

Because "one-on-one" discussions, although routine, are inherently more risky than public presentations, executives should be well coached by counsel in the nuances of Regulation FD, their talking points should be vetted by counsel, and potential risky areas should be scripted with counsel in advance to avoid selective disclosures.

In the event of concerns about the disclosure of material nonpublic information, corrective disclosure under Regulation FD should be considered immediately.

The SEC's press release, complaint and settlements are available [here](#).

If you would like to discuss these or any other governance or securities law matters, please contact any member of Ropes & Gray's [Securities & Public Companies](#) practice or your usual Ropes & Gray advisor.