Implied Disclosure Can Violate Regulation FD

On October 21, 2010, the SEC announced a settlement of an enforcement action against Office Depot, its CEO and CFO, for violating Regulation FD. Office Depot paid a fine of $1 million and each of the officers paid fines of $50,000. The CEO resigned four days after the SEC's announcement. The CFO had previously resigned.

The SEC charged that Office Depot had violated Regulation FD in June 2007 by selectively communicating to analysts and institutional shareholders that it would not meet analysts' quarterly earnings estimates. Interestingly, Office Depot did not directly tell the analysts that it would not meet their expectations. Instead, at the urging of the CFO, the director of investor relations called all 18 analysts who covered Office Depot and made reference to recent public statements of comparable companies about the impact of the slowing economy on their earnings, and reminded them of Office Depot's prior cautionary public statements. Office Depot continued to make the calls despite the CFO's being notified of the fact that some analysts had expressed concerns about, among other things, the lack of public disclosure.

Significant Facts Highlighted by the SEC in its Cease and Desist Order

Office Depot, following company policy, did not offer specific quarterly earnings guidance during the relevant time period. On May 31, 2007, the CEO alerted Office Depot's board of directors and the executive committee that the company would not likely meet the analysts' consensus $0.48 earnings per share ("EPS") estimate for the second quarter and that senior management was discussing a strategy for advance communication to avoid a complete surprise to the market.

On June 20, 2007, ten days prior to the close of Office Depot's second quarter, the CEO and the CFO, both of whom had investor relations experience, discussed how to encourage analysts to revisit their estimates. The CEO, in an attempt to have analysts lower their estimates, proposed to the CFO that the company talk to the analysts and refer them to recent earnings announcements by two comparable companies that had publicly announced results that were impacted by the slowing economy. The CEO further suggested that Office Depot point out on the calls the company's cautionary statements from April and May 2007. The CEO believed that if the analysts looked at Office Depot again in that light, they would conclude that their estimates were too high and likely would lower them.

The CFO, the director of investor relations and the director's immediate supervisor drafted talking points, based in part on the CEO's suggestions, for use as a guide for the calls with analysts. On Friday, June 22, 2007, and the following Monday, June 25, 2007, the director of investor relations spoke individually with all 18 analysts covering Office Depot and conveyed to them the information contained in the talking points. Office Depot did not regularly initiate calls with analysts covering the company. Word of these calls quickly spread among analysts, some of whom believed that Office Depot was "talking down" analysts' earnings estimates.

On Monday, June 25, 2007, the CFO asked the immediate supervisor of the director of investor relations whether the director of investor relations had contacted a particular analyst whose EPS estimate was the highest and had not yet been revised. On the same day, the CEO requested and received an update, which showed that the analysts' consensus EPS estimate had only been lowered to $0.46. The CEO then commented to the director of investor relations that the company still needed to have conversations with a few more analysts.

Office Depot's calls influenced many analysts to revise and lower their second quarter 2007 forecasts. By the end of the second day of the calls, fifteen of the eighteen analysts had lowered their estimates, bringing the consensus EPS estimate down from $0.48 to $0.45. Late on Monday, June 25, 2007, the CFO also told the director of investor relations to call the 20 largest institutional investors and relay the talking points to them.

Six days after the calls began, Office Depot filed its Form 8-K announcing to the market, among other things, that its sales and earnings would be negatively impacted due to a continued soft economy. Between the initiation of the calls and the time the Form 8-K was filed, Office Depot's share price had dropped approximately 7.7% on increased trading volume.

In making its findings, the SEC did not allege that the talking points contained material non-public information, but that they implied material non-public information. In its Order, the SEC quoted from the release adopting Regulation FD, which emphasized that the information did not have to be explicit to violate Regulation FD:

"When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect 'guidance,' the meaning of which is apparent though implied."

Conclusion

The SEC's complaint and Cease and Desist Order are not surprising. The information conveyed, although not specific, appears to have been intended to achieve the selective disclosure that Regulation FD prohibits. Although the CEO and CFO did not participate directly in the calls, the calls were clearly made at their urging and under their supervision. Office Depot tried to disclose indirectly what it knew it could not disclose directly. The SEC's action should serve as a reminder that trying to convey information to analysts one-on-one, without public disclosure, is a dangerous course of action that could result in an SEC enforcement action.

One other fact that the SEC deemed significant, that Office Depot had no written Regulation FD policy and no formal training for company personnel, should also serve as a warning to companies that are in similar circumstances. A written policy and formal training probably would not have influenced the SEC's enforcement action, but it might have educated the Office Depot executives sufficiently for them to have followed a different course of action.

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