

## *Client Alert*

# SEC Enforcement: District Court Dismisses “Nit-Picking” Allegations of Regulation FD Violations

On August 31, 2005, Judge Daniels of the Southern District of New York dismissed a complaint brought by the Securities and Exchange Commission against Siebel Systems, Inc. and two of its senior officers for alleged violations of Regulation FD based on certain statements made by the company’s Chief Financial Officer at two private events attended by institutional investors. Regulation FD prohibits issuers from selectively disclosing material, nonpublic information without simultaneously making public disclosure of the same information. The SEC’s complaint in essence alleged that the CFO privately made comments about the company’s business activity levels and sales transaction pipeline that were more positive than and in material contrast to public statements made during conference calls earlier that same month. In dismissing the complaint in its entirety, Judge Daniels effectively concluded that the SEC was attempting to apply Regulation FD in an overly aggressive manner that was inconsistent with the regulation’s purpose of encouraging broad disclosure of relevant information. The Court felt that the SEC’s scrutiny of the publicly and privately disclosed information was at such a heightened level, involving as it did even the verb tenses and general syntax of each sentence, that it placed “an unreasonable burden on a company’s management and spokespersons to become linguistic experts, or otherwise live in fear of violating Regulation FD should the words they use later be interpreted by the SEC as connoting even the slightest variance from the company’s public statements.” This, the Court concluded, went beyond anything that Regulation FD required.

### **Regulation FD**

Regulation FD prohibits issuers,<sup>1</sup> senior officials of the issuer, or any other officer, employee, or agent of the issuer who regularly communicates with securities market professionals or the issuer’s security holders, from selectively disclosing material, nonpublic information to a class of persons outside the issuer where there is no simultaneous disclosure of the information to the public. This class of persons includes: (1) broker-dealers; (2) investment advisers and certain institutional investment managers; (3) investment companies and hedge funds; and (4) any holder of the issuer’s securities under circumstances where it is reasonably foreseeable that the holder would purchase or sell securities on the basis of the information disclosed.

Information is material for purposes of Regulation FD if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision or

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<sup>1</sup> Under Rule 101(b) of Regulation FD, an “issuer” is any company with securities registered under Section 12 or which is required to file reports under Section 15(d) of the Exchange Act.

if the information would significantly alter the total mix of available information. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Regulation FD distinguishes between “intentional” and “non-intentional” selective disclosures of material, nonpublic information. The disclosure is “intentional” when the person knows, or is reckless in not knowing, that the information being communicated is both “material” and “nonpublic.” A failure to comply with Regulation FD will subject an issuer to an enforcement action for violations of Section 13(a) or 15(d) of the Exchange Act and Regulation FD.

## SEC Complaint

***SEC v. Siebel Systems, Inc., Kenneth A. Goldman and Mark D. Hanson, 04 CV 5130 (S.D.N.Y.):*** The SEC brought the enforcement action against Siebel Systems, Inc., the company’s Chief Financial Officer, Kenneth Goldman, and one of the company’s Senior Vice Presidents, Mark Hanson. In addition to charging the defendants with violating Regulation FD, the complaint also alleged that the company had violated Section 13(a) of the Securities Exchange Act of 1934 by failing to maintain disclosure controls and procedures designed to ensure the proper and timely handling of information required to be disclosed in periodic reports under the Exchange Act. The defendants moved to dismiss the complaint on the grounds that the alleged statements disclosed were neither material nor nonpublic and therefore did not state a claim under Regulation FD.

The complaint alleged that Goldman had privately disclosed material, nonpublic information at two events in April 2003 that were attended by institutional investors. Goldman was alleged to have stated that Siebel Systems’s activity levels were “good” or “better,” that new deals were coming back into the pipeline, that the pipeline was “building” and “growing,” and that “there were some \$5 million deals in Siebel’s pipeline.” The complaint further alleged that shortly after these disclosures, certain investors in attendance and their associates made substantial purchases of shares of Siebel’s stock. The SEC claimed that these positive comments about the company’s improving results materially contrasted with public statements made by Thomas Siebel, the company’s founder, chairman and CEO, during two conference calls and a conference earlier in April.

The prior public statements made by Siebel provided information about the company’s performance in the first quarter of 2003 and its expected performance in the second quarter. The SEC alleged that Siebel had reported that its first quarter results were poor because the economy was poor, that some deals had slipped into the second quarter, and that the company expected software license revenue to be higher in the second quarter, but had conditioned its expectation on the performance of the overall economy. The SEC characterized Siebel’s statements as linking the company’s prospective performance to the overall economy’s performance and suggesting that economic conditions were negative or at least as not improving.

In contrast, the SEC contended, Goldman’s private statements were significantly more upbeat and positive, and were not linked to the performance of the economy. The SEC’s complaint alleged that Goldman made four specific nonpublic, material disclosures: (1) that there were some *five-million dollar deals* in the company’s pipeline for the second quarter of 2003; (2) that *new deals* were coming into the pipeline; (3) that the company’s sales pipeline was “growing” or “building”; and (4) that the company’s sales or business activity levels were “good” or “better”. The complaint did not allege that Goldman had made any statements about specific earnings or sales figures.

## The Court's Decision

In analyzing these purportedly nonpublic, material statements, the Court began by noting that in adopting Regulation FD the SEC had recognized the difficulties involved in making instant materiality judgments and the risk that Regulation FD could have an unfortunate “chilling effect” on the disclosure of information with a cost to the overall market. The Court noted that while the SEC had declined to provide a bright line test or define “materiality” for purposes of Regulation FD other than as set forth generally in the case law, the SEC had identified seven categories of information or events that have a higher probability of being considered material.<sup>2</sup> The Court found it significant that none of the challenged statements by Goldman fell squarely within the enumerated categories.

The Court also compared in detail each of the four alleged disclosures made by Goldman against the earlier public statements by the company and concluded that none of them could support the conclusion that material information had been privately communicated. For example, the Court noted that Goldman’s statement regarding the existence of five-million dollar deals in the company’s pipeline for the second quarter “was equivalent in substance” to the information previously disclosed. During the earlier conference call, Siebel had stated with respect to guidance for the second quarter that “I think that we’ll see lots of small deals. We’ll see some medium deals. We’ll see a number of deals over a million dollars. And I suspect we’ll see some greater than five.” The SEC maintained that Goldman’s statement was materially different in that it was stated in the *present* tense, in contrast to Siebel’s forward looking statement that he “suspected” there would be some five-million dollar deals.

The Court rejected this argument, noting that it was an exercise in excessive linguistic scrutiny and placed an unreasonable burden on the company’s management and spokespersons. “Regulation FD,” the Court held, “does not require that corporate officials only utter verbatim statements that were previously publicly made.” The Court noted that Goldman’s private statement regarding the existence of five million dollar deals in the company’s pipeline for the second quarter was equivalent in substance to the information previously publicly disclosed by the company, as it conveyed the same material information:

“As long as the private statement conveys the same material information that the public statement publicly conveyed, Regulation FD is not implicated, and hence no greater form of disclosure, pursuant to the regulation, is required. Although Mr. Goldman’s statement was not literally a word for word recitation of Mr. Siebel’s disclosure, both provided the same

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<sup>2</sup> The seven enumerated categories are: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or supplies (*e.g.*, the acquisition or loss of a contract); (4) changes in control or in management; (5) changes in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report; (6) events regarding the issuer’s securities - *e.g.*, defaults on strict securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to rights of security holders, public or private sales of additional securities; and (7) bankruptcies and receiverships. SEC’s Adopting Release, 65 Fed. Reg. 51716, at 51721.

information, and Mr. Goldman's statement did not add, contradict or significantly alter the material information available to the general public. It therefore cannot constitute a sufficient factual basis on which to allege a nonpublic disclosure of material information in violation of Regulation FD."

The Court rejected the SEC's arguments about the other three alleged private material statements for similar reasons, concluding that, although not identical to the prior public statements, they did not alter the total mix of public information already available to the reasonable investor.

In making its materiality argument, the SEC had also placed great emphasis on the alleged fact that certain individuals who were in attendance when Goldman spoke, and others with whom they communicated, purchased Siebel Systems stock almost immediately after the presentation or soon thereafter, "causing the market for Siebel Systems stock to significantly rise and for trading to surge." The Court acknowledged that a major factor in determining whether information is material is the importance attached to it by those who learn the information as expressed by their reaction to the information. But the Court concluded that, although a relevant factor, the mere fact that analysts might have considered Goldman's statements significant was not, standing alone, sufficient to change the nature or content of his statements, or to infer that Regulation FD was violated. As the Court reasoned, "The regulation does not prohibit persons speaking on behalf of an issuer, from providing mere positive or negative characterizations, or their optimistic or pessimistic subjective general impressions, based upon or drawn from the material information available to the public."

## Conclusion

The dismissal of the SEC's complaint against Siebel Systems and two of its senior officers represents a significant chastisement of the SEC for having sought to enforce Regulation FD in a manner that relied too heavily on linguistic nit-picking and grammatical parsing of public and non-public statements. The Court was concerned here with the potential "chilling effect" that such a complaint might have on the flow of relevant information to the investing public, and the unreasonable burden that it would place on company management and spokespersons. It was clearly significant to the Court's analysis, however, that the alleged material private disclosures were in the nature of general positive characterizations and impressions which could reasonably be drawn, the Court felt, from the available public information, and did not fall squarely into one of the seven enumerated categories or contain any specific earnings or sales information.

Although issuers may take some solace from the Court's decision, it is but the first judicial interpretation of Regulation FD, and its impact on the SEC's approach to enforcement of Regulation FD remains to be seen. The SEC has filed a notice of appeal to the Court of Appeals for the Second Circuit from the Court's decision. We urge issuers to continue to carefully consider any proposed private disclosures in light of the requirements of Regulation FD.

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