# SELECTIVE DISCLOSURE:

## A RECENT HIGH PROFILE US CASE HIGHLIGHTS THE RISKS OF TRYING TO MANAGE MARKET EXPECTATIONS

By David Whittaker*

The recent Office Depot case in the US provides a relevant example of what not to do when seeking to be proactive in managing expectations. In our view, Australian regulators will continue to look at how the US experience can be applied to Australian financial markets.

**This case illustrates the problems with trying to manage market expectations rather than facing up to the reality of a public announcement.**

The disclosure case brought by the Securities and Exchange Commission (SEC) against Office Depot was settled with US$1 million in fines paid by the company and $50,000 each by the CEO and CFO.

The SEC says when it became apparent the company would not meet quarterly consensus, in order to prevent a surprise Office Depot began a coordinated campaign to manage down estimates.

### Test of selective disclosure regulations

The case was seen as an important test of US Regulation 'FD' (Fair Disclosure), a rule introduced in 2000 that seeks to prevent selective disclosure of market sensitive information. In the case against Office Depot, the SEC alleged:

- Office Depot violated Regulation FD in 2007 by selectively communicating to analysts that it would not meet consensus quarterly earnings estimates. After a discussion between the company's CEO and then-CFO, Office Depot conducted one-on-one calls with the analysts (via the Investor Relations Officer).
- The company did not directly tell the analysts that it would not meet their expectations; rather, this message was signaled through its references to recent public statements of comparable companies about the impact of the slowing economy on their earnings, and reminders of Office Depot's prior cautionary public statements. The analysts promptly lowered their estimates for the period.
- The CFO and the CEO were aware of the declining estimates while the company made the calls, and they encouraged the calls to be completed. The company also continued to make the calls despite being notified of some analysts' concerns of, among other things, the lack of public disclosure.
- Six days after the calls began Office Depot filed a release announcing that its earnings would be negatively impacted due to a continued soft economy. Prior to the release, the share price had dropped significantly on increased trading volume.

### Nudge, nudge, wink, wink ...

Notably, management seemed to believe that because it was only referring to its own previous public statements and the profit results and comments of industry peers, it was not breaching the rules on the release of non-public information.

However, the SEC has previously ruled that selective disclosure of earnings information cannot come in the form of "indirect guidance, the meaning of which is apparent though implied." Providing a wink or nod, or a coded response calculated to convey indirectly information is no different to telling an analyst point-blank, "Our earnings will be down 10% this quarter."

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Under Regulation FD, the company is required to either stay mum completely about the impending earnings disappointment, letting everyone know together at results time (periodic disclosure); or if it believes it must disclose sooner, disclose publically via a formal filing.

### Implications for Australian companies

Under the Australian continuous disclosure regime there is no option to wait to disclose. Office Depot would have had an automatic duty to disclose once it realised earnings would materially miss consensus or guidance. Australian regulators have been clear on this issue noting that "selective briefings create opportunities for insider trading and also undermine ordinary investor confidence in the market as a level playing field".

### Guidelines for investor briefings and road shows

ASIC's view is that briefings play an important role in increasing the dissemination of accurate information on companies to the market. They enable management to explain the company's financial results, business strategies and outlook and they provide analysts with the opportunity to question and evaluate management.

ASIC's guidelines for analyst/investor briefings:

- Pre-releasing any briefing information to the ASX and posting it on the company website;
- Post briefing, reviewing discussions with analysts and investors to check whether there has been selective disclosure;
- Managing earnings expectations via continuous disclosure which may include establishing an earnings forecast range and only changing the range via public announcements;
- Confining comments on financial forecasts and reports to factual errors and underlying assumptions;
- Having appropriate policies and procedures that focus on continuous disclosure including maintaining a website and appointing a senior compliance officer.

### Australian enforcement

Under the latest reforms the ASX will remain the front line supervisor on continuous disclosure but will continue to work with ASIC on detection and enforcement. In Australia, the penalties for breaching the relevant section 674 of the Corporations Act range from fines of $33,000 to $100,000 to much heavier civil and criminal penalties, including fines of up to $1 million and jail terms.

But there have been just seven civil cases brought before the courts in the last decade with only four resulting in penalties totalling just $680,000. The ASIC appeal on the high profile Fortescue/Forrest case is being heard later this month with a decision likely early in 2011.

Australia implemented an infringement notice regime in 2004 giving ASIC the flexibility to tackle breaches outside the courts. Companies that comply with the infringement notice do so without an admission of guilt or liability. There have been more than a dozen actions settled under this system with fines exceeding $600,000; at least three of which were against ASX Top 20 companies[1].

### Structured investor relations minimises risk

Key take-outs for Australian companies from the Office Depot case include:

- Listed companies should not take for granted that they are complying with disclosure requirements; they need to establish and regularly review IR practices and processes;
- Companies should be aware of market consensus and if it diverges materially from reality the only mechanism available for correcting analysts is public disclosure;
- A nod and a wink campaign which seeks to selectively massage estimates by stealth is prohibited in both the US and Australia;
- Regulators have been pursuing disclosure breaches using a range of mechanisms; penalties are significant but the potential damage to corporate and management reputation also remains a key consideration.

1. With thanks to Dr Josephine Coffey, Faculty of Economics and Business, The University Sydney.

* The author, David Whittaker, has 18 years financial markets experience. FIRST Advisers designs and manages best practice investor relations and communications programs which meet investor demands while maximising the effectiveness of scarce management time. The firm also provides transaction based services including takeover communications, IPO support, retail and institutional solicitation, beneficial ownership analysis and company secretarial services.