

## Rare court decision in Regulation FD litigation highlights risks of calls with analysts

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A federal district court decision involving alleged Regulation FD violations highlighted analysis of key elements governing the regulation relating to whether information is material and nonpublic, and provides multiple takeaways on evaluating the risk of one-on-one calls with analysts.

### Background

On September 8, Judge Engelmayer of the Southern District of New York denied motions for summary judgment filed by both the SEC and the defendants in litigation alleging Regulation FD violations. The defendants included AT&T and three individuals who worked in the company's investor relations department. The decision puts the case on a path toward trial (absent settlements).

Regulation FD prohibits a company from selectively disclosing material, nonpublic information (MNPI) to certain securities professionals or others likely to use the information to trade, such as analysts and investors, unless the company also discloses the information to the public. Although the court found the evidence overwhelmingly supported the SEC's claims that the information at issue was both nonpublic and material, it determined that a reasonable jury could find for either side on the third element, scienter.

Because most Regulation FD cases brought by the SEC are settled, the court's evaluation of the claims and defenses provides insight for companies deciding whether certain communications with analysts might violate Regulation FD.

### Materiality of information conveyed to analysts

At the time in question, most of AT&T's revenues were derived from providing services rather than equipment upgrades, and it generally did not make money on equipment upgrades so that revenues from such upgrades had a very minor bottom line impact. In both Q3 and Q4 of 2015, AT&T had failed to meet analysts' consensus estimates for revenue, and in the months leading up to the announcement of Q1 2016 results, executives and employees were sensitive to avoiding another revenue miss. The court noted that internal documents and emails demonstrated a concerted effort to "walk down analysts' estimates" for that quarter.

AT&T was facing reduced wireless equipment upgrade rates and decreased equipment revenue because of changes in its reliance on charging customers for new phones up front and because customers were more reluctant to upgrade to new versions. This development was highlighted by two executives, including the CFO, at public conferences in March, and the CFO at the conference strongly hinted that this trend would continue, but many analysts did not revise their estimates as a result. The Company then followed up with calls to analysts, and they provided specific data points for metrics documenting the downward trend on these private phone calls.

The defendants argued that the upgrade rate and equipment revenue metrics were quantitatively insignificant, because wireless equipment revenue had amounted to less than 10% of the total revenue, and the information shared with analysts would only impact total revenue by less than 5%. Additionally, defendants argued that while earnings results were material, total revenue was not material because of the inconsistent impact on earnings and that equipment revenue had a very small bottom line impact.

The court disagreed and found that the three metrics that were communicated in private calls to analysts were material despite the minor effect these metrics have on earnings. The court focused on the emphasis placed by AT&T in its prior public statements about these metrics, as well as the numerous records demonstrating internal concern surrounding missing analyst expectations due to these metrics. In particular, the court noted that “[m]issing consensus can cause concern among investors,” and is therefore often material.

## Whether the information conveyed was nonpublic

AT&T did not dispute that the values of the metrics themselves were not publicly available, but argued that at least the upgrade rate could be extrapolated by both investors and analysts using public information. Defendants posited that the downward trends in wireless upgrade rates and wireless equipment revenue reflected industry trends that were well-known, and that applying the same percentage reduction in these metrics that had occurred year-over-year would allow the analysts to separately derive the same upgrade rate decline that was communicated to them by the defendants.

The court focused instead on the use of nonpublic information by the defendants when they spoke to analysts and the analysts’ subsequent behavior after those conversations. The AT&T employees conveyed nonpublic quarterly financial information, and analysts “repeatedly adjusted their estimates downward” promptly after phone calls with AT&T, which supported the conclusion that the information they heard during the calls was new.

The company further argued that the information was public because AT&T executives, including the CFO, had shared the same information previously at two Regulation FD-compliant conferences in early March. The court disagreed, noting that the executives clearly had not disclosed the quarterly results that the company’s investor personnel disclosed when they called the analysts, and instead spoke only to general trends and the prior quarter’s results rather than provide data about the most recent quarter. When one executive did address the declines in upgrade rates and equipment revenue, and was asked to provide specific data, he responded that “it’s not something we publicly disclose” and referred again to the general trend.

Additionally, these conferences occurred much earlier in the quarter than the subsequent calls made to analysts and investors, which continued in an attempt to adjust or keep down consensus, right up until the day before quarterly results were released. While consensus estimates were initially adjusted somewhat following the CFO’s comments at one of the conferences, defendants were unsuccessful in arguing that analysts understood the magnitude of these trends based solely on the CFO’s comments because estimates were adjusted even further by analysts, and at times more meaningfully, following the private calls.

## Scienter remains in doubt

Regulation FD requires that “the individual making the disclosure must know (or be reckless in not knowing) that he or she would be communicating information that was both material and nonpublic.” The court cited the multiple points of evidence in support of scienter, including the number of analyst calls in which defendants disclosed confidential information; the variety of internal data that the defendants disclosed; the sustained duration (six weeks) of these disclosures and the general internal concern and persistence until the earnings estimates were brought down.

But the court explained that a jury could find the defendants had only acted negligently because of the lack of direct evidence of defendants or supervisors expressing a conscious disregard for securities laws or company policies. The court also said that it was possible that a jury could believe that they had not appreciated that the information was material or nonpublic at the time it was shared.

## Key takeaways

***Certain actions continue to be most risky.*** Calls to analysts in advance of the reporting of quarterly earnings remains risky, especially if the purpose of the calls is to adjust analysts’ expectations. Calls immediately following an earnings call that points to those public results should remain relatively low risk. But the risk increases as the quarter progresses and is especially heightened when company personnel making the calls, or instructing personnel to make the calls, have

nonpublic information about the quarter's results. Risk may also be heightened if quarterly earnings have not yet been announced but company personnel convey to analysts how the quarter is trending compared to expectations.

**Materiality will be viewed in hindsight.** Companies must make difficult materiality judgments all the time, but the SEC, courts and juries will judge those decisions in hindsight. Here, AT&T claimed the three metrics disclosed to the analysts in private conversations were not material because they did not materially impact the company's financial performance. But the court was not convinced as it viewed the information, such as total revenue, to constitute key financial metrics, especially as the metrics determined whether the company would meet or miss consensus expectations.

**It is difficult to prove that information is already public when company personnel use nonpublic results in their conversations.** AT&T argued that the information already was public because it was consistent with known industry trends, and consistent with statements previously made publicly by the executives at conferences. The decision though relied in part on the fact that the personnel who called analysts had access to, and conveyed, nonpublic information to make their point.

**Public statements should be specific and clear.** SEC filings and Regulation FD-compliant forums offer opportunities for companies to update and clarify potential confusion in the market, but only if the information conveyed is sufficiently specific. The statements made by AT&T's CFO at a conference were public, but the court determined that he did not convey any new information with enough specificity that the analysts would have understood the impact to revenues.

**Senior leadership at companies is often implicated.** Past SEC enforcement cases usually charged senior leadership at companies, including CEOs, CFOs and heads of investor relations. The only individual defendants in this case were three employees working in investor relations, though the court pointed out that the adopting release for Regulation FD stated that senior management would be responsible if they "directed" employees to make selective disclosures.

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