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SEC Update

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SEC alleges Reg FD violation for selective disclosure to analysts aimed at reducing consensus revenue estimate

The SEC recently filed a civil suit in federal district court against AT&T, Inc. charging the company with violating Regulation FD in 2016 by selectively disclosing nonpublic financial estimates and results to sell-side analysts before the company issued its quarterly earnings release. The SEC alleges that the purpose of the disclosure was to "walk the analysts down" by inducing them to lower their revenue estimates for the first quarter so that the consensus revenue estimate would be in line with the revenue AT&T expected to report. The SEC also charged three members of the company's investor relations department who participated in the analyst calls with aiding and abetting the company's violation.

AT&T is contesting the SEC's allegations. In a public statement, the company disputes the SEC's claim that the information conveyed to the analysts constituted material nonpublic information and contends that the action, brought five years after the alleged violation, "represents a significant departure from the SEC's own long-standing Regulation FD enforcement policy."

The company's decision to oppose the action may result in a fuller exposition of the circumstances that led to the charges. The enforcement position reflected in the SEC's complaint, however, merits careful attention now by companies and the officials authorized to act on their behalf in disclosures subject to Regulation FD.

You can view the SEC's complaint here and AT&T's public statement here.

SEC allegations

The SEC's suit against AT&T looks to enforce Regulation FD (for Fair Disclosure), which prohibits selective disclosure of material nonpublic information by or on behalf of an issuer to securities analysts and others identified in the regulation unless the issuer simultaneously disseminates the same information to the public by a disclosure method reasonably designed to provide broad, non-exclusionary distribution. The SEC's complaint alleges that AT&T provided nonpublic quarterly financial estimates and results to securities analysts to steer them to lower their individual estimates of the company's total consolidated revenue for the first quarter of 2016.

AT&T's selective disclosure focused on the portion of its revenue derived from sales of smartphones to cellular subscribers, which the company reported as wireless equipment revenue. Beginning in 2015, a number of trends had contributed to declining revenue from smartphone sales, including a decrease in the rate at which customers traded in their phones to AT&T for upgrades, which the market referred to as the equipment upgrade rate.

The SEC alleges that analysts' failure to appreciate the full impact of the trends contributed to consensus revenue estimates – the average of the forecasts of all analysts covering AT&T – that exceeded AT&T's reported total revenue for the first, third, and fourth quarters of 2015. On the company's earnings call in January 2016, the chief financial officer highlighted the trends contributing to the diminished wireless equipment revenue and, in the SEC's formulation, "telegraph[ed] the likelihood that these impacts would persist into future quarters." The chief financial officer reiterated this message at an investor conference held on March 9.

The SEC alleges that the company's "revenue miss" for the fourth quarter of 2015, measured by the difference between the consensus estimate and the actual results, "caused consternation within AT&T's IR department." The IR department forecast in March, from internal estimates, and confirmed in early April, from actual results, that a record-low equipment upgrade rate for the first quarter and a steeper-than-expected decline in smartphone sales would contribute to a more than US$1 billion shortfall in reported total revenue as compared to the consensus estimate.

The SEC alleges that, after the investor conference in March, the IR department pursued "a plan to contact individual analyst firms whose estimates were higher than AT&T's projections." According to the complaint, the purpose of the outreach was to induce the analyst firms "to lower their revenue forecasts by a total dollar amount that, in the aggregate, was large enough to lower the consensus estimate to an amount AT&T could meet."

As described in the complaint, the three individual IR department members charged in the action held private, one-on-one phone calls with approximately 20 sell-side analyst firms covering AT&T. The analyst calls were held over a six-week period from March 9 through April 21 that ended five days before AT&T reported its first quarter results. During the calls, the IR officials disclosed the estimated and, later, actual equipment upgrade rate and wireless equipment revenue amount for the first quarter and, in the SEC's words, "otherwise communicated to the analysts, in sum and substance, that the analysts' revenue estimates were above what AT&T was expecting to report and therefore needed to be reduced."

The SEC alleges that all of the analyst firms reduced their revenue estimates soon after the calls and almost all of the firms cited a record-low equipment upgrade rate and reduced wireless equipment revenue as the primary reasons for the lower estimates. AT&T reported US$40.535 billion in total revenue for the first quarter, which the SEC alleges exceeded the revised consensus revenue estimate by less than US$100 million.

Materiality of selectively disclosed information

In its public statement, AT&T disputes the SEC's determination that the company's IR personnel disclosed material nonpublic information in the analyst calls. Under the materiality test defined by the U.S. Supreme Court, information is material to an issuer if there is a substantial likelihood that a reasonable investor would consider the information important in deciding whether to buy or sell the issuer's securities. To fulfill the materiality requirement, there must be a substantial likelihood that a reasonable investor would view the information as having significantly altered the "total mix" of information made available.

Allegations in the complaint. The SEC's complaint highlights several factors that – whether considered individually or as a whole – apparently convinced the Enforcement Division and, ultimately, the Commission that the information conveyed on the analyst calls was material to AT&T.

Context of the selective disclosure. The SEC suggests that AT&T was motivated by a desire to avoid an adverse investor reaction that would have resulted from an announcement that its consolidated revenue had fallen short of the consensus revenue estimate for the third consecutive quarter.

The SEC frames its allegations by repeating the following warning it issued in 2000 in the Regulation FD adopting release:

> One common situation that raises special concerns about selective disclosure has been the practice of securities analysts seeking "guidance" from issuers regarding earnings forecasts. 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 will likely 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.

The SEC further addresses the materiality of earnings guidance by observing that investors and markets compare the financial results of companies like AT&T to the consensus estimates compiled from analyst forecasts, and typically treat the failure of actual results to meet those estimates "as negative news for the issuer." This view is supported by market studies reporting that issuers often experience a drop in their stock price when they release financial results that are below analyst estimates.

Nature of selectively disclosed information. The selective disclosure involved information of the type the SEC has characterized as material in the adopting release and earlier Regulation FD enforcement actions. The SEC identifies as material two types of information AT&T disclosed in the analyst calls, depending on the analyst firm and the date of the call:

- (a) the equipment upgrade rate for the first quarter of 2016 and (b) the wireless equipment revenue amount for the quarter (expressed as a percentage decrease from the reported revenue amount for the first quarter of 2015), which were derived from internal forecasts and, later, actual results and were not publicly available; and
- "independently conveyed, apart from the specific details," the nonpublic information that the analysts' "revenue and related estimates were higher than AT&T's expected results."

In the adopting release, the SEC said that, although not *per se* material, "earnings information" is one of the types of information that "should be reviewed carefully to determine whether they are material." The SEC has charged violations of Regulation FD in prior actions for the selective disclosure to analysts and other covered recipients of results for revenue, sales, earnings, earnings per share, and other earnings measures. Further, in accordance with its admonition in the adopting release, the SEC has affirmed in prior enforcement actions that it generally considers information about earnings guidance and estimates to be material.

Internal characterization of selectively disclosed information. The SEC alleges that the company itself considered the disclosed information to be material. The complaint states that the company's Regulation FD training materials "specifically informed the IR Department personnel that AT&T's revenue and sales of smartphones were types of information generally considered 'material' to AT&T investors." The complaint suggests that this characterization of the materiality of the information may have led one of the IR staff members participating in the calls to tell analysts that he was giving them publicly available consensus estimates rather than the company's internal forecasts.

In addition, as presented by the SEC, the company managed its public communications in a way that suggests it recognized that the type of information at issue would be of market interest. The complaint indicates that the chief financial officer elected to address the "accelerating downward trend in the upgrade rate and wireless equipment revenue" at the March 9 investor conference after the company had considered, and decided against, issuing a Form 8-K report to discuss this development. In his presentation, the chief financial officer declined an invitation by the conference host to provide guidance on wireless equipment revenue and related financial measures for the first quarter of 2016, instead referring investors to the prior quarter's published results.

Other considerations. The SEC may have given weight in its materiality determination to other features of the outreach effort. The complaint contains the following additional allegations.

- *Targets*: The IR officials contacted only analysts whose revenue estimates were higher than AT&T's forecasts.
- *Results*: Each of the analyst firms lowered its estimates after considering the information disclosed on the calls.
- *Direction*: The outreach to analysts was pursued at the direction of AT&T's chief financial officer and under the supervision of the IR director, who monitored the progress of the effort and reported its successful conclusion to the chief financial officer and the company's chief executive officer.

AT&T's public statement. AT&T contests the SEC's materiality determination on a number of grounds.

Prior market communications about materiality. AT&T emphasizes that, before the analyst calls, it had "made clear" in its public disclosures "that the declining phone sales had no material impact on its earnings." According to the company, the market had absorbed this view, as "investors understood that AT&T's core business was selling connectivity (i.e., wireless service plans), not devices, and that smartphone sales were immaterial to the company's earnings."

Of the total consolidated revenue of US$40.535 billion AT&T reported for the first quarter of 2016, wireless equipment revenue, which included revenue from smartphone sales, accounted for US$1.77 billion.

Prior market communications about revenue trend. The company's statement also refers to the company's prior public disclosures about the reasons for the declining smartphone sales and their impact on the company's operating results. AT&T states that it "had publicly disclose[d] this trend on multiple occasions" before the analyst calls. The company contends that, as a result, the "conversations" with the analysts "concerned the widely reported, industry-wide phase-out of subsidy programs for new smartphone purchases and the impact of this trend on smartphone upgrade rates and equipment revenue."

This aspect of the company's statement suggests that, in light of its public disclosures about the negative trends associated with smartphone sales, including adverse revenue impact reported for prior quarters, AT&T believes that the results for the 2016 quarter communicated to analysts did not significantly add to the "total mix" of information made available.

Lack of market reaction to published results. AT&T maintains that the market understanding of the immateriality of the selectively disclosed information was confirmed by "the lack of any market reaction to AT&T's first quarter 2016 results."

In prior Regulation FD enforcement actions – consistent with the Supreme Court's materiality test which focuses on the effect of information on an investment decision – the SEC has looked to see if the issuer's stock price or trading volume registered a significant increase or decrease upon public dissemination of the selectively disclosed information. The SEC has affirmed in other enforcement cases that such a market reaction can be an important indication of the materiality of the information, and is more likely to impose penalties if stock price or volume is affected by the violation.

In this action, the significance of the lack of market activity upon AT&T's release of earnings may be clouded by the fact that the objective of bringing consensus estimates into line with actual results is to forestall a drop in stock price or increase in trading volume that would follow announcement of an earnings miss.

The SEC's complaint does not indicate – and AT&T's statement does not address – whether AT&T's stock price or volume reacted to the issuance of revised analyst estimates over the period leading up to the release of quarterly earnings.

No acknowledgement of materiality by participants. AT&T contends that "after spending four years investigating this matter, the SEC does not cite a single witness involved in any of these analyst calls who believes that material nonpublic information was conveyed to them."

The absence of recognition by participants in the analyst calls that they were discussing material nonpublic information would distinguish this action from some of the prior enforcement actions involving selective disclosure to analysts. In the earlier actions, the summary of the charges presented in the consent order revealed that company officials who conveyed information to analysts generally understood they were selectively disclosing material nonpublic information. In addition, the charges in one action indicated that some of the analysts had questioned whether the selective disclosure was permitted under Regulation FD.

Discussion

Since it adopted Regulation FD 20 years ago, the SEC periodically has brought enforcement actions to establish boundaries for permissible communications of nonpublic information to analysts and other securities market professionals and security holders covered by the regulation. The SEC's lawsuit against AT&T reaffirms a prominent theme of previous enforcement actions and sounds a strong cautionary note against management of earnings expectations of the type charged in the complaint.

In this action, as in previous enforcement actions, the SEC has demonstrated its continuing concern over selective disclosure regarding earnings guidance and estimates. In prior actions, the SEC has charged companies, and in some cases their authorized representatives, for violating the regulation by:

- disclosing internal quarterly and semi-annual earnings guidance to analysts in one-on-one telephone calls and characterizing analysts' quarterly earnings estimates as "too high," "aggressive," or "very aggressive";
- reaffirming in a private meeting with analysts an annual EPS estimate which the company had previously disclosed publicly;
- disclosing in an e-mail to analysts, in the form of "some additional color" on the company's quarterly EPS guidance announced to the public, that an updated internal forecast indicated actual EPS results for the quarter would be lower than the published guidance; and
- "signaling" adverse operating expectations in one-on-one telephone calls to analysts and the company's principal institutional investors as part of a plan to "talk down" analysts' EPS estimates for a quarter – and thereby reduce the consensus EPS estimate – by referring to public statements of comparable companies and prior cautionary statements by the issuer.

Further, in a report of investigation under Regulation FD, the company found that a company had selectively disclosed to an analyst material information by quantifying the company's reference to a "significant weakness" in sales and orders which the company had announced in a press release.

The practice of "talking down" analysts' estimates may not be uncommon, as some media reports suggest (including an article in the financial press in 2016 that highlighted conduct by AT&T described in the SEC's complaint). The lesson of the pending case and prior enforcement actions, however, is that these types of communications continue to risk attracting enforcement interest.

Companies may use Regulation FD-compliant ways to encourage analysts to revisit and revise erroneous assumptions that underpin their earnings estimates. As reflected most recently in the AT&T complaint, however, the SEC raises a significant concern whether companies comply with the regulation when they quantify for analysts qualitative information that has been publicly disclosed. The SEC's resistance to the augmentation of trend and other qualitative disclosures with selectively disclosed numerical data precludes assurance that the discussion of such data with an analyst would not be considered to involve material nonpublic information.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed in this update.

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