

Client Alert

SEC Enforcement: Reaffirmation of Earnings Guidance in Violation of Regulation FD

On March 24, 2005, the Securities and Exchange Commission filed its first Regulation FD enforcement case involving a reaffirmation of earnings guidance by an issuer and against an investor relations officer for violating this rule. Regulation FD prohibits issuers from selectively disclosing material, nonpublic information without simultaneously making public disclosure of the same information. The settled enforcement action was against Flowserve Corporation, its Chairman, President and Chief Executive Officer, C. Scott Greer, and its Director of Investor Relations, Michael Conley. Flowserve and Greer also consented to the entry of final judgment by a federal court requiring them to pay civil penalties of \$350,000 and \$50,000, respectively. Consistent with the SEC's previous Regulation FD actions against Raytheon Company and Siebel Systems, and its 21(a) Report of Investigation regarding Motorola, Inc., the Flowserve case emphasizes the SEC's expectation that issuers will take Regulation FD's prohibitions seriously, even in the context of a reaffirmation of earnings guidance. This latest case also demonstrates that the SEC is prepared to hold responsible the internal "gate keepers" such as the Director of Investor Relations whose responsibility it was to draft and enforce the company's Regulation FD policy.

Regulation FD

Regulation FD prohibits issuers,¹ 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 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

¹ 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.

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 Administrative Proceeding

In the Matter of Flowserve Corporation, C. Scott Greer, and Michael Conley, Release No. 34-51427: The settled administrative enforcement proceeding against Flowserve, its Chairman, President and CEO, Greer, and its Director of Investor Relations, Conley, found that Flowserve had violated Regulation FD and Section 13(a) of the Securities Exchange Act of 1934, and that Greer and Conley were each a cause of the company’s violations. The Order found that Flowserve had violated Regulation FD when, in hosting a two-day private meeting with analysts from four investment and brokerage firms, selective disclosures were made reaffirming² the company’s earnings guidance issued nearly a month earlier.

Reporting on a calendar-year basis, Flowserve began 2002 by forecasting annual earnings per share (“EPS”) in the range of \$1.90 to \$2.90. These estimates were repeatedly revised downward as the year progressed. In July of that year, Flowserve estimated EPS at \$1.70 to \$1.90, and on September 27th, the EPS estimates were further revised downward to \$1.45 to \$1.55. This last earnings guidance was reaffirmed on October 22, 2002, in the company’s Form 10-Q. As the Order observed, the \$1.45 to \$1.55 range reaffirmed on October 22nd represented a 30% decline in EPS estimates since the beginning of the year.

On November 19th, almost a month after the last earnings announcement and only forty-two days before the end of the company’s fiscal year, Greer and Conley met privately with analysts from four investment and brokerage firms to discuss various aspects of Flowserve’s business and provide them with a tour of the company’s facilities in Irving, Texas. At some point during the meeting, one of the analysts inquired about the company’s earnings guidance for the year. The enforcement Order stressed that neither Greer nor Conley gave the response that was required under the company’s policy regarding earnings guidance. Instead of stating that earnings guidance was effective at the date given and would not be updated until the company made a public announcement, as required, Greer reaffirmed for the analysts the company’s previous guidance issued a month earlier. Conley, the Director of Investor Relations, remained silent throughout this exchange.

² The SEC has previously cited in this context the adopting release for Regulation FD in which the SEC explained: “One 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 private discussions 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 analysts 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.” *Final Rule: Selective Disclosure and Insider Trading*, Release No. 34-43154 (Aug. 15, 2000) (emphasis added).

On November 20th, one of the analysts who attended the meeting at Flowserve issued a report to subscribers of Thompson's First Call discussing as one of its key points the fact that Flowserve had reaffirmed its earlier earnings guidance. After trading as much as 9% higher during the day on November 21st, Flowserve's stock price closed 6% higher than the day before. Moreover, the trading volume that day represented a 75% increase over the previous day's volume. Following the market close on November 21st, Flowserve issued a Form 8-K which stated: "During a conversation this week with securities analysts, Flowserve Corporation reaffirmed its full year 2002 estimated earnings per share"

The enforcement Order concluded that Flowserve, through its CEO, Greer, had "intentionally" and selectively disclosed material, nonpublic information to securities market professionals when Greer reaffirmed Flowserve's continued confidence in its earlier earnings guidance. In concluding that Conley, the Director of Investor Relations, was also a cause of Flowserve's violations, the Order noted by way of background that Flowserve has had a Regulation FD disclosure policy in place since 1999, and that the 2001 version of that policy "mandated a specific response" to questions regarding earnings guidance, as noted above. Conley was the principal author of Flowserve's policy and was the person responsible for its implementation. The Order appeared to take fault with Conley's conduct at the analyst meeting not only for failing to caution Greer before he answered the analyst's question about earnings guidance, but also for failing to do anything to explain Greer's statements following the exchange. Even though the statement had already been made, the Order seemed to suggest that Conley should have reiterated the company's policy with respect to earnings guidance. At minimum, the failure to follow the company's Regulation FD policy made it easy for the Commission to find that the disclosure was "intentional" in that Greer and Conley were at last reckless in not knowing that the information being disclosed was both material and non-public.

Interestingly, in a footnote, the Order noted that in addition to the underlying conduct detailed above, the Commission also considered "the Respondents' lack of cooperation afforded the Commission staff." This lack of cooperation, the Order revealed, was premised on the fact that "both Greer and Conley denied that a reaffirmation occurred at the meeting, which is inconsistent with the Form 8-K." No further details were provided.

Flowserve, Greer, and Conley, without admitting or denying the findings by the SEC, were ordered to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act or Regulation FD.

Conclusion

The case against Flowserve, Greer, and Conley reiterates that the SEC's view that it expects issuers to pay close adherence to the prohibitions under Regulation FD, including with respect to reaffirmations of previously disclosed earnings guidance. This case is also noteworthy for its emphasis on the inaction by one of Regulation FD's primary internal gate keepers, the Director of Investor Relations, whose responsibilities included enforcing the company's disclosure policy. By remaining silent in the face of an analyst inquiry and subsequent disclosure by the company's CEO, the Director of Investor Relations, the SEC concluded, was as much a cause of the company's violation as the CEO who made the actual disclosure.

For Additional Information

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