

## CLIENT ALERT

APRIL 2005

# SEC BRINGS ENFORCEMENT ACTION AGAINST PUBLIC COMPANY FOR CONFIRMING GUIDANCE

Securities and Exchange Commission Regulation Fair Disclosure ("Regulation FD") forbids companies from selectively disclosing material nonpublic information to members of the financial community ahead of the public. Since it adopted Regulation FD in 2000, the SEC has charged only a few companies with violations of the rule. A recent SEC enforcement action for a Regulation FD violation provides insight as to what circumstances may lead the SEC to file charges in a Regulation FD investigation, and reinforces the need for the management of public companies to be careful in private meetings with financial analysts. The recent case, which involved Flowserve Corporation, is the first action under Regulation FD in which the SEC charged a company (and its CEO, individually) for reaffirming previous earnings guidance to a select group. As detailed below, in this case, the company's lack of cooperation with the SEC also appears to have triggered a more aggressive response from the SEC's enforcement division.

### **Background**

Flowserve's disclosure policy, in place since 1999, required that, when asked questions about earnings guidance, company representatives were to respond that the current guidance was effective at the date given and was "not being updated until the

company publicly announces updated guidance."

Throughout 2002, Flowserve (a calendar-year-reporting corporation) revised its earnings guidance downward three times—in July, September, and October. By October, Flowserve's guidance was 30 percent lower than the range provided at the beginning of the year. On November 18-19, 2002, Flowserve hosted a private-analyst event that included a meeting with executives. The SEC noted in its administrative order that Flowserve's director of investor relations, Michael Conley, did not "caution the analysts as to what topics were off limits" during their conversations with the chief executive officer, Scott Greer.

On November 19, the analysts met with Greer and Conley. This meeting took place only 42 days before the end of Flowserve's fiscal year and nearly one month after the company's prior public statement concerning guidance. When the analysts asked about Flowserve's earnings guidance, Greer reaffirmed the October guidance, thereby providing material nonpublic information. The SEC remarked in its administrative order that neither Conley nor Greer gave the response required by the company's policy, nor did Conley caution Greer before he answered, or attempt to explain Greer's statements after

they were made. Conley also "failed to reiterate" the company's disclosure policy.

The following day, an analyst who had attended the meeting issued a report to the investment firm's customers stating that Flowserve had reaffirmed its earnings guidance. The analyst's report listed the reaffirmation as the second of its five "Key Points" on the company, and was the subject of the first substantive paragraph in the report's "Discussion" section. On November 21, Flowserve's closing stock price was approximately 6 percent higher than the closing price the day before, and trading volume increased by 75 percent.

After the market closed that day, Flowserve issued a Form 8-K stating that, earlier in the week, the company had met with analysts and reaffirmed its full-year 2002 earnings estimates. Under Regulation FD, filing a Form 8-K is one method of curing a "non-intentional" violation of the rule, but the filing must be completed "promptly."

The SEC's administrative order and civil complaint noted that Flowserve filed the Form 8-K "more than 53 hours" after the reaffirmation of the guidance and "nearly 26 hours" after the analyst's report was issued. The rule defines "promptly" to mean "as soon as reasonably practicable (but in no

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event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange)." Therefore, the Form 8-K was not issued "promptly" within the meaning of the rule.

## Lack of Cooperation

More important, the SEC charged Flowserve and Greer with an intentional violation.<sup>1</sup> On the facts available, including the issuance of an 8-K to publicly disseminate the information, it is not clear that the violation was, in fact, intentional. But, in its administrative order and press releases, the SEC highlighted the company's "lack of cooperation" with SEC staff.

Specifically, when questioned by the staff, both Conley and Greer denied that any reaffirmation had taken place at the meeting.

The SEC found this denial inconsistent with the text of the 8-K furnished by the company, which stated that a reaffirmation had taken place.

In addition, Conley's failure to caution analysts before the meeting, or to explain Greer's statements, seemed to trouble the SEC, as it may have evinced a lack of concern about a possible Regulation FD issue. The two-day delay before filing a corrective 8-K also may have contributed to the SEC's stance in this investigation.

On March 24, 2005, Flowserve agreed to pay a \$350,000 fine to settle the SEC action, and Greer agreed to pay \$50,000 individually. Flowserve, Greer, and Conley also agreed to cease and desist from future violations of Regulation FD.

## Lessons Learned

The Flowserve action makes clear that the SEC will pursue selective disclosure of material information even where the disclosure is only a reaffirmation of previously issued guidance. The SEC did not indicate how long after a company issues guidance it may confirm that guidance privately without running afoul of Regulation FD, although it had previously advised that there might be instances early in a quarter and shortly after the issuance of public guidance where a private reaffirmation would not run afoul of Regulation FD. In the case of Flowserve, the confirmation was a little less than one month after the prior public guidance. The safer course is for a company never to change or

confirm guidance in any non-public forum. Instead, any mention of guidance in a nonpublic meeting with analysts or investors should be limited to stating that the company's guidance was current as of the date given, and that it is the company's policy not to update or confirm guidance except in an FD-compliant manner. The action also reinforces the need for public companies to be wary of any one-on-one conversations with analysts, particularly toward the end of a quarter.

The Flowserve action also provides two lessons in how to handle a problem when it arises. First, Regulation FD provides for curing non-intentional violations by issuing a public disclosure no later than 24 hours or the start of the next day's trading in the stock. A prompt disclosure in the event of a non-intentional violation is essential. In this case, the company took over 53 hours to issue the public reaffirmation of guidance. Second, the SEC has stressed on many occasions that it expects public companies to cooperate actively whenever it conducts an investigation. In this case, the SEC emphasized the company's "lack of cooperation," and noted that the individuals had denied that guidance has been confirmed even though the company's subsequent public disclosure admitted that it had.

For more information on the Flowserve enforcement action and its implications, please contact a member of Wilson Sonsini Goodrich & Rosati's securities litigation or corporate practice.



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<sup>1</sup>Under Regulation FD a disclosure is "intentional" when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic. "Non-intentional" is not defined by the rule.