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RECENT SEC "REGULATION FD" ACTION MERITS ATTENTION OF PUBLIC COMPANIES

by

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In a sign that the Securities and Exchange Commission (SEC) remains committed to enforcing its Regulation Fair Disclosure (Reg. FD), the Commission recently settled an enforcement action against Flowserve Corporation, its CEO, and its Director of Investor Relations for selective disclosure in violation of Reg. FD. This action is significant, in part, because it is the first alleging a Reg. FD violation based on reaffirmation of previous earnings guidance. It also is the first settled enforcement action brought against an investor relations officer under Reg. FD.

This enforcement action is a reminder that public companies and their spokespersons should be extremely cautious when discussing or confirming earnings estimates. In adopting Reg. FD, the SEC warned that private discussions with analysts about estimated earnings present a "high degree of risk," and that providing selective earnings guidance to an analyst would likely result in a Reg. FD violation.

Background. During 2002, Flowserve issued a series of steadily declining estimates of its annual earnings per share. On November 19, 2002, Flowserve's CEO and Director of Investor Relations met privately with securities analysts. In response to an analyst's question, the CEO allegedly reaffirmed Flowserve's most recent earnings guidance, which the company had previously reaffirmed in a Form 10-Q on October 22, 2002. The Director of Investor Relations remained silent. The SEC characterized the CEO's response as an intentional disclosure. Flowserve's disclosure policy required that, in response to such a question, company spokespersons were to respond that "the current earnings guidance was effective at the date given and is not being updated until the company publicly announces updated guidance." The Director of Investor Relations was the principal author of the disclosure policy and was responsible for its implementation.

One of the analysts issued a report the following day which highlighted the fact that Flowserve had reaffirmed its prior earnings guidance. The next day, Flowserve's stock price closed up 6% on significantly increased trading volume compared to the previous day. After the market closed that day, about 53 hours after the CEO's disclosure and 26 hours after the analyst released the report, Flowserve furnished a Form 8-K to the SEC disclosing that the company had reaffirmed its earnings guidance during an analyst meeting. The CEO and Director of Investor Relations later denied that the earnings guidance was reaffirmed.

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The SEC brought an administrative proceeding against Flowserve and its CEO and Director of Investor Relations, and a civil suit against Flowserve and the CEO. Without admitting or denying the SEC's allegations, Flowserve and the executives consented to a cease-and-desist order, and civil money penalties of \$350,000 for Flowserve and \$50,000 for the CEO were assessed. This is the first settled enforcement action brought against an investor relations officer under Reg. FD.

Regulation FD. Reg. FD generally prohibits an issuer, or its senior officials or persons who regularly communicate with securities professionals or security holders, from selectively disclosing material, nonpublic information to a securities professional (such as a broker, analyst or investment advisor) or to a security holder under circumstances where the holder might trade in the securities on the basis of the information. If, as in the *Flowserve* case, the disclosure is intentional, the issuer is required to make simultaneous public disclosure of the information by filing or furnishing a Form 8-K with the SEC or through some other broad, non-exclusionary means (such as a press release). "Intentional" in this context means that the person making the disclosure knows, or is reckless in not knowing, that the information is both material and nonpublic. If the disclosure is non-intentional, the issuer must publicly disclose the information as soon as reasonably practicable but no later than the later of 24 hours or the commencement of the next day's trading, once a senior official of the issuer learns of the non-intentional disclosure.

Analysis and Recommendations. The SEC's approach and emphasis in *Flowserve* merits special consideration by public companies, their executives, and others involved in corporate communications.

- Exercise caution when reaffirming even recent earnings guidance. There is no "bright line" between when a public company may or may not selectively reaffirm prior earnings guidance. Rather, it involves significant judgment. In a telephone interpretation, the SEC staff has stated that companies should consider whether the reaffirmation conveys material additional information, which may depend on how much time has elapsed since the prior guidance and whether the reaffirmation is near the end of a reporting period. In *Flowserve*, the reaffirmation was made about 28 days after the prior guidance and 42 days before the end of Flowserve's fiscal year. Although an issuer may be able to selectively confirm earnings guidance in some situations (such as early in a quarter and a few days after public disclosure of prior guidance), it and its spokespersons should carefully consider timing, intervening events (such as Flowserve's rapid decline in performance) and other circumstances before doing so.
- Don't ignore your responsibilities for corporate communications. The SEC's approach in *Flowserve* suggests that investor relations personnel and others responsible for corporate communications face potential liability under Reg. FD for failing to carry out those responsibilities or intervene in improper disclosure. In imposing a cease-and-desist order against Flowserve's Director of Investor Relations, the SEC emphasized his responsibilities and his failure to caution analysts about off-limit topics or speak up or act when a question about earnings guidance was asked.
- Be familiar with and adhere to your disclosure policy. Adopting a well-crafted disclosure policy can be an important part of a public company's Reg. FD compliance efforts and disclosure controls and procedures; however, it is imperative that companies go beyond mere adoption and actually follow and familiarize executives with the policy.
- Carefully consider the risk of not cooperating with the SEC. In assessing sanctions in *Flowserve*, the SEC noted that it took into consideration the lack of cooperation with SEC staff by Flowserve and its executives. This is consistent with the SEC's position that, in determining whether and how to take enforcement action, it will give credit for self-policing, self-reporting, remediation and cooperation with SEC staff and other law enforcement authorities.