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SEC Settles Regulation FD Case Involving a Non-Public Reaffirmation of Earnings

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On March 24, 2005, the Securities and Exchange Commission ("SEC") charged Flowserve Corporation ("Flowserve"), a U.S. manufacturer of precision-engineered flow control equipment, with violating Regulation FD and Section 13(a) of the Securities and Exchange Act of 1934. The SEC also charged Flowserve's Chief Executive Officer, C. Scott Greer, and Director of Investor Relations, Michael Conley, with causing Flowserve's violations. Flowserve, Greer and Conley consented to a cease-and-desist order. In addition, Flowserve must pay a civil penalty of \$350,000 and Greer must pay a civil penalty of \$50,000.

This is the first case filed by the SEC for a Regulation FD violation involving an issuer's non-public reaffirmation of earnings as well as the first settled enforcement action against a Director of Investor Relations for violating Regulation FD.

Regulation FD and Section 13(a) Violations

The SEC charged Flowserve with violating, and its CEO and Director of Investor Relations with causing such violations of, Regulation FD. Regulation FD prohibits issuers from selectively disclosing material nonpublic information to certain persons, such as securities analysts, while not disclosing the same information to the public. Under Regulation FD, "intentional" disclosures of material nonpublic information require simultaneous public disclosure of the same information. Per Rule 101(a) of Regulation FD, a disclosure is intentional if the person making the disclosure either knows that the information being communicated is both material and nonpublic or is reckless in not knowing.

The SEC also charged Flowserve with violating, and its CEO and Director of Investor Relations with causing such violations of, Section 13(a) of the Securities and Exchange Act of 1934. Section 13(a) requires companies with securities registered under Section 12(b) to file with the SEC certain reports and other information "necessary or appropriate for the protection of investors and to insure fair dealing in the security." Such reports include Form 8-K filings.

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Overview of the Case Against Flowserve, the CEO and the Director of Investor Relations

Flowserve is a calendar year company listed on the New York Stock Exchange. From as early as 1999, Flowserve had a disclosure policy, the 2001 version of which mandated a specific response to earnings guidance questions. In periods subsequent to an official Flowserve public announcement regarding earnings guidance, spokespersons for Flowserve were instructed to respond to questions regarding earnings guidance by stating: "Although business conditions are subject to change, in accordance with Flowserve's policy, the current earnings guidance was effective at the date given and is not being updated until the company publicly announces updated guidance."

Flowserve's original public forecast of annual earnings in 2002 of \$1.90 to \$2.30 per share was revised downward by Flowserve in July to \$1.70 to \$1.90 per share, and was lowered again in September to \$1.45 to \$1.55 per share. In its Form 10-Q filed with the SEC on October 22, 2002, Flowserve reaffirmed its \$1.45 to \$1.55 per share earnings guidance.

On the morning of November 19, 2002, Flowserve's CEO and Director of Investor Relations met privately with analysts. During this meeting an analyst asked about Flowserve's earnings guidance for the year. Instead of giving the response required by Flowserve's disclosure policy with respect to earnings guidance questions, the CEO reaffirmed Flowserve's previous public guidance, issued on October 22, 2002, and provided additional material nonpublic information. The Director of Investor Relations remained silent throughout the meeting.

On November 20, 2002, an analyst in attendance at the November 19th meeting issued a report stating that Flowserve had reaffirmed its earnings guidance. The next day, November 21st, Flowserve's stock price closed approximately 6% higher and trading volume increased by approximately 73%. After the market closed on November 21st, over 53 hours after its selective disclosure of information and almost 26 hours after the analyst report was distributed, Flowserve furnished a Form 8-K in which it acknowledged that it had reaffirmed its full year 2002 estimated earnings per share guidance in a conversation with a securities analyst during the week.

Practice Points

- ▶ **Companies must follow their prescribed disclosure policies, taking necessary precautions to avoid reckless disclosure of material nonpublic information.** Flowserve's CEO failed to follow Flowserve's disclosure policy and Flowserve's Director of Investor Relations failed to caution analysts as to off limit topics of inquiry.
- ▶ **Silence by the Director of Investor Relations can be a violation.** Flowserve's Director of Investor Relations was both the principal author of Flowserve's Regulation FD policy and the person responsible for its implementation. The Director of Investor Relations had a duty to speak when the CEO gave an inappropriate answer, and had a duty to reiterate Flowserve's disclosure policy as to earnings guidance. Remaining silent was a violation, and therefore the SEC charged him with causing Flowserve's violations.



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- ▶ **The SEC is increasingly scrutinizing the actions and inactions of the Director of Investor Relations.** In both the SEC's settled enforcement action against Flowserve and its pending action against Siebel Systems, the SEC has focused on the role the Director of Investor Relations played in failing to prevent a material nonpublic disclosure of information, thereby signaling the SEC's desire for a public company's Director of Investor Relations to play an active and assertive role in such company's disclosure of information to the public.

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