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Latest Regulation FD Enforcement Action Reaffirms the Danger of Privately Discussing Earnings Guidance

On March 24, 2005, the SEC announced its first Regulation FD case involving reaffirmation of earnings guidance, which is also its first settled Regulation FD enforcement action against a director of investor relations.[1] The SEC's enforcement action against Flowserve Corporation, its CEO and its IR director for intentionally violating Regulation FD by privately reaffirming Flowserve's earnings guidance is causing many companies to refocus on the fact that the mere reaffirmation of guidance can constitute material nonpublic information.

Regulation FD

Regulation FD prohibits a public company from intentionally disclosing material nonpublic information to specified types of market professionals, such as securities analysts, broker-dealers and investment advisers, or to security holders, unless the company publicly discloses the information simultaneously. In addition, if a company "non-intentionally" discloses material nonpublic information to persons covered by Regulation FD, the company must publicly disclose the information as soon as reasonably practicable after relevant company personnel learn of the disclosure, but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange. A disclosure is "non-intentional" if the company was not aware (and was not reckless in being unaware) that the information was material or that the information had not previously been publicly disclosed.

The Flowserve Enforcement Action

The SEC's Factual Allegations and Findings

Flowserve, a calendar-year reporting company, publicly provided earnings guidance of $1.90 to $2.30 per share for full year 2002. In July 2002, Flowserve reduced its estimate to $1.70 to $1.90 per share. On September 27, 2002, Flowserve further lowered its estimate to $1.45 to $1.55 per share. Flowserve reaffirmed this last estimate in its Form 10-Q filed on October 22, 2002.

On November 19, 2002, at a private meeting with analysts from four investment and brokerage firms, an analyst inquired about Flowserve's 2002 earnings guidance. In response, Flowserve's CEO reaffirmed the company's October 22 earnings guidance.[2] This response was contrary to Flowserve's disclosure policy, which provided that company spokespersons should respond to questions about previously announced earnings guidance as follows: "Although business conditions are subject to change, in accordance with Flowserve's policy, the current earnings

1. See *SEC Files Settled Regulation FD Charges against Flowserve Corporation, its Chief Executive Officer, and Director of Investor Relations*, SEC Press Release No. 2005-41 (March 24, 2005), available at http://www.sec.gov/news/press/2005-41.htm; *Securities and Exchange Commission v. Flowserve Corporation and C. Scott Greer,* Litigation Release No. 19154 (March 24, 2005), available at http://www.sec.gov/litigation/litreleases/lr19154.htm.

2. The administrative order and complaint also state that the CEO "provided additional material nonpublic information" but do not elaborate on what it was or on its significance to the enforcement action.

guidance was effective at the date given and is not being updated until the company publicly announces updated guidance." Flowserve's IR director, who was present at the meeting, did not caution the CEO prior to his response and remained silent following the CEO's response.

On November 20, 2002, an analyst who had attended the private meeting released a report stating that Flowserve had reaffirmed its earnings guidance. The next day, Flowserve's stock price rose 6% and its trading volume increased by 75%.

After the market closed on November 21, more than 53 hours after the private reaffirmation and nearly 26 hours after the release of the analyst's report, Flowserve submitted a Form 8-K stating that it had reaffirmed its earnings guidance during a conversation with securities analysts earlier that week.

The SEC's Charges and Settlement

On March 24, 2005, the SEC filed a lawsuit in the United States District Court for the District of Columbia charging Flowserve with violating Section 13(a) of the Exchange Act and Regulation FD, and charging Flowserve's CEO with aiding and abetting the company's violations. Also on March 24, 2005, the SEC issued an administrative order finding that Flowserve had violated Section 13(a) of the Exchange Act and Regulation FD and that Flowserve's CEO and IR director were each a cause of these violations.[3]

In settlement, Flowserve and its CEO consented to civil penalties of $350,000 and $50,000, respectively, without admitting or denying any wrongdoing. Flowserve, its CEO and its IR director also consented to the issuance by the SEC of an order requiring them to cease and desist from any future violations.

Analysis and Key Lessons

Any Information Relating to Earnings, Including the Mere Reaffirmation of Prior Guidance, Has a High Likelihood of Being Material

In the adopting release promulgating Regulation FD, the SEC warned that: "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 likely will have violated Regulation FD."[4] In addition, the first question and answer contained in the SEC staff's 2000 interpretative guidance on Regulation FD addressed the issue of company reaffirmations and warned that:

> "In assessing the materiality of an issuer's confirmation of its own forecast, the issuer should consider whether the confirmation conveys any information above and beyond the original forecast and whether that additional information is itself material. That may depend on, among other things, the amount of time that has elapsed between the original forecast and the confirmation (or the amount of time elapsed since the last public confirmation, if applicable). For example, a confirmation of expected quarterly earnings made near the end of a quarter might convey information about how the issuer actually performed. In that respect, the inference a reasonable investor may draw from such a confirmation may differ significantly from the inference he or she may have drawn from the original forecast early in the quarter. The materiality of a confirmation also may depend on, among other things, intervening events. For example, if it is clear that the issuer's forecast is highly dependent on a particular customer and the customer subsequently announces that it is ceasing operations, a confirmation by the issuer of a prior forecast may be material."[5]

Judged against the factors previously outlined by the SEC staff, two red flags probably had a significant influence on the outcome in

3. See *In the Matter of Flowserve Corporation, C. Scott Greer and Michael Conley*, Exchange Act Rel. No. 51427 (March 24, 2005); Complaint, *Securities and Exchange Commission v. Flowserve Corporation and C. Scott Greer* (March 24, 2005).
4. See *Selective Disclosure and Insider Trading*, SEC Release Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99 (August 15, 2000).
5. See *Fourth Supplement to SEC Division of Corporate Finance Manual of Publicly Available Telephone Interpretations*, Question 1 (October 2000).

this case. First, since its initial full year 2002 guidance, Flowserve had already lowered its guidance twice during the second half of the year, most recently in late September. Even though Flowserve reaffirmed its September guidance in its October 22 10-Q filing, the significance of the previous guidance reductions—especially when considered in light of the widespread economic uncertainty that existed in late 2002—should have made the company officials aware that any subsequent reaffirmation could be of significant interest to investors. Second, the reiteration was made when there were only 42 days remaining in the fiscal year to which the guidance related.

The Flowserve case reinforces that there is no set number of days after publicly providing guidance within which it is always safe to reaffirm that prior guidance. Instead, as in the case of other materiality judgments, any time a company decides to reaffirm prior guidance, it must consider all the facts on a qualitative basis—including how long it has been since the guidance was last publicly provided; how late in the fiscal period the reaffirmation is being made; what intervening events have occurred at the company, in its industry and in the general economy; and the context in which the company is being asked to provide the reaffirmation (for example, the fact that analysts are pushing very hard for the information could itself be a red flag as to the materiality of the information).

Given the need to qualitatively assess materiality, no rule of thumb based on the number of days since guidance was publicly provided can be blindly followed. In light of this, companies would be well served to adopt and adhere to a policy prohibiting any nonpublic statements about earnings guidance. For companies that do not adopt such a blanket policy, but instead qualitatively assess materiality on a case-by-case basis, we recommend being especially cautious about privately confirming guidance more than one week after it was publicly disclosed or at any time during the last 45 days of the fiscal period to which the guidance relates.

Senior IR Professionals Have Compliance Responsibilities

Flowserve may be the first settled Regulation FD enforcement action brought by the SEC against an IR professional, but it is not the first time an SEC enforcement action has highlighted the conduct of a senior IR professional. In its 2002 enforcement action against Secure Computing, the SEC noted that the company's IR director sat by quietly while the CEO made non-intentional disclosures of material nonpublic information.[6] In the SEC's first enforcement action against Siebel in 2002, Siebel was fined for statements made by the CEO in a meeting that the CEO believed was being webcast, when in fact it was not, and the IR director failed to inform him of this fact.[7] In the SEC's second enforcement action against Siebel, which is the subject of ongoing litigation, the SEC has charged the IR director with aiding and abetting Siebel's violations of the SEC's prior cease and desist order, Section 13(a) of the Exchange Act and Regulation FD in connection with allegedly disclosing material nonpublic information during private meetings with institutional investors.[8]

Through its enforcement actions, the SEC is underscoring its view that IR professionals share in the company's obligation to prevent or mitigate Regulation FD violations. In Flowserve, the SEC is critical of the failure of the IR director to establish ground rules with the analysts as to what topics would be off-limits during the private meeting with the CEO. Moreover, regardless of how awkward it might be, the SEC clearly expects IR professionals to step in and take action when it appears that a company executive has selectively disclosed, or is about to selectively disclose, material nonpublic information.[9]

6. See *In the Matter of Secure Computing Corporation and John McNulty*, Exchange Act Rel. No. 46895 (November 25, 2002).
7. See *In the Matter of Siebel Systems, Inc.*, Exchange Act Rel. No. 46896 (November 25, 2002).
8. See Complaint, *Securities and Exchange Commission v. Siebel Systems, Inc., Kenneth A. Goldman and Mark D. Hanson* (June 29, 2004).
9. In the Flowserve cease and desist order, the SEC says: "Neither [the IR director] nor [the CEO] gave the response required by the Company's policy that earnings guidance was effective at the date given and would not be updated until the Company publicly announced updated guidance. [The IR director] did not caution [the CEO] before [the CEO] answered the analyst's questions. In fact, [the IR director] remained altogether silent. . . Having heard the exchange between [the CEO] and the analyst, again [the IR director] was silent and did nothing to explain [the CEO's] statements. [The IR director] also failed to reiterate the Company policy as to earnings guidance."

In light of the compliance role that they serve, IR professionals should:

- help ensure the company's disclosure policy accurately reflects company practice and if not, change the policy or the practice, as appropriate (including, for example, by reviewing the company's policy on responding to requests for guidance updates to ensure that any scripted answer called for by the policy could not be misinterpreted as constituting a reaffirmation of guidance);[10]
- play a leading role in educating officers, employees, directors and agents who communicate with market professionals and stockholders about what the company's disclosure policy requires; and
- establish with the company's senior executives how the IR professional will discharge his or her obligations to help prevent or mitigate Regulation FD violations (including, for example, by always setting ground rules before one-on-one meetings and by having the CEO momentarily pause before answering questions in order to give the IR professional a chance to interject if an analyst's question is out of bounds).

If You Make a Mistake, Fix it Promptly

Regulation FD provides a way to cure non-intentional disclosures by promptly releasing the information to the public. However, regardless of whether an unplanned disclosure satisfies the definition of "non-intentional," a company should immediately mitigate any selective disclosure of material nonpublic information by issuing a press release or submitting a Form 8-K. The Flowserve case demonstrates that even a small delay in making corrective disclosure (in Flowserve, the Form 8-K was submitted approximately 53 hours after the private reaffirmation and approximately 26 hours after the release of the analyst's report) is too long.

Companies should put procedures in place in advance that address how they will respond to unplanned disclosures of information. Importantly, Flowserve again underscores the SEC's view that violations of Regulation FD involve a failure to timely submit a Form 8-K and therefore also constitute a violation of a company's Section 13(a) reporting obligations and may indicate that a company does not maintain effective disclosure controls and procedures.

Don't Compound Your Problems

The following footnote to the Flowserve administrative order suggests that the SEC staff's interest in pursuing this case, as well as the severity of the penalties levied, was influenced by how the parties handled the SEC investigation: "In addition to the underlying conduct, the Commission considered the Respondents' lack of cooperation afforded the Commission staff. Specifically, both [the CEO] and [the IR director] denied that a reaffirmation occurred at the meeting, which is inconsistent with the Form 8-K."

10. While the fact that the reaffirmation was made in violation of Flowserve's own disclosure policy does not appear to have been a significant factor in the SEC's decision to charge the company and its CEO, statements by SEC staff members indicate that it was an important factor in the decision to sanction the IR director, who was the person in Flowserve's organization responsible for drafting and implementing the company's disclosure policy.

If you have any questions or need additional information, please contact:

Meredith B. Cross
202 663 6644
meredith.cross@wilmerhale.com

Erika L. Robinson
202 663 6402
erika.robinson@wilmerhale.com

Patrick J. Rondeau
617 526 6670
patrick.rondeau@wilmerhale.com

Jeffrey B. Rudman
617 526 6912
jeffrey.rudman@wilmerhale.com

Knute J. Salhus
212 230 8805
knute.salhus@wilmerhale.com

Jessica S. Semerjian
202 663 6886
jessica.semerjian@wilmerhale.com

Harry J. Weiss
202 663 6993
harry.weiss@wilmerhale.com

Thomas W. White
703 251 9701
thomas.white@wilmerhale.com

Jonathan Wolfman
617 526 6833
jonathan.wolfman@wilmerhale.com