

Client Alert

A report
for clients
and friends
of the firm April 2005

Recent SEC Enforcement Action Against Flowserve Focuses Attention on Regulation FD Compliance

On March 24, 2005, the SEC charged Flowserve and its CEO and Director of Investor Relations with Regulation FD violations based on an affirmation, in a private meeting with analysts, of earnings guidance that Flowserve had publicly disclosed previously. Flowserve and its officers entered into a consent decree requiring the company and the CEO to pay civil penalties and consenting to the SEC's issuance of a cease-and-desist order against all three defendants. The enforcement action took many executives by surprise and received considerable attention in the business press—this is the first time the SEC took enforcement action based on a reaffirmation of previously released earnings guidance and also the first settled action against a Director of Investor Relations for a Regulation FD violation. A close examination of the facts reveals that while the outcome in this case is consistent with both the spirit and the letter of Regulation FD, the failure of Flowserve and its officers to follow their own disclosure policies and procedures, and their lack of cooperation with the SEC, were factors considered by the SEC.

Regulation FD Overview

The SEC promulgated Regulation FD in 2000 to codify the prohibition on selective disclosure of material nonpublic information. The Regulation is designed to eliminate what many believe to be the unfair advantage that Wall Street insiders have in terms of access to material nonpublic information.

Regulation FD prohibits a public-company issuer, or anyone acting on the issuer's behalf, from disclosing material nonpublic information to securities analysts, broker-dealers, investment advisers and institutional investors prior to disseminating the same information to the public. For purposes of Regulation FD, information is deemed material 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.

Regulation FD requires an issuer to make simultaneous public disclosure of material nonpublic information that is intentionally disclosed to certain industry participants and investors, while unintentional disclosures of material nonpublic information may be remedied by promptly disseminating the information to the public. A disclosure is deemed intentional if the person making the disclosure knows, or is reckless in not knowing, that the information being communicated is both material and nonpublic.

Flowserve Enforcement Action

Flowserve had initially forecast its 2002 annual earnings per share in the range of \$1.90 to \$2.30. In July 2002, the company revised its earnings guidance downward to \$1.70 to \$1.90 per share. On September 27, 2002, Flowserve further revised its estimate to a range of \$1.45 to \$1.55 per share, an estimate that the company reaffirmed in its Form 10-Q, filed on October 22, 2002.

On November 19, 2002, during a private meeting with analysts from investment and brokerage firms, Flowserve's CEO, C. Scott Greer, was asked about the company's earnings guidance. In response, Mr. Greer reaffirmed the company's earnings guidance that had been last affirmed on October 22, 2002. Flowserve's Director of Investor Relations, Michael Conley, who was present during the analyst questions, did not caution or prevent Mr. Greer from answering, despite

the fact that Flowserve had a disclosure policy mandating that a company spokesperson respond to such an inquiry 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." The following day, an analyst that attended the meeting issued a report to the investment firm's subscribers stating that Flowserve had reaffirmed its earnings guidance. On November 21, 2002, Flowserve filed a Form 8-K, stating that the company had met with analysts earlier in the week and reaffirmed its previously disclosed full-year earnings estimate.

The SEC commenced enforcement proceedings against Flowserve and Messrs. Greer and Conley. While the SEC viewed Mr. Greer's disclosure as "intentional," even if the disclosure was deemed "nonintentional," the SEC indicated that the company's Form 8-K—filed two days after the private analysts meeting—would not have satisfied the Regulation FD requirement of "prompt" dissemination of the disclosure to the public.

While not admitting or denying the charges, Flowserve, Mr. Greer and Mr. Conley consented to the entry of a final judgment pursuant to which Flowserve is required to pay a \$350,000 penalty and Mr. Greer is to pay a \$50,000 penalty and pursuant to which all three defendants have agreed to the entry of a cease-and-desist order.

Practical Guidance

The *Flowserve* enforcement action highlights the necessity for company management to be careful when speaking in a nonpublic forum, particularly to market professionals, including analysts. Discussing earnings guidance is particularly sensitive. The SEC has stated that a company that "engages in a private discussion with an analyst who is seeking guidance about earnings estimates...takes on a high degree of risk under Regulation FD."

Effective compliance with Regulation FD begins with establishing and maintaining adequate disclosure controls and procedures that not only ensure compliance with Regulation FD when first announcing earnings guidance, but also address requests that management reconfirm previously issued guidance. The response policy adopted, but not followed, by Flowserve would be effective, as would a policy of responding to such questions with "no comment."

By naming Flowserve's Director of Investor Relations as a party to the SEC's administrative action, the SEC is effectively putting investor relations personnel on notice that they have a central role in compliance with Regulation FD.

Investor relations personnel, as well as management, should be well versed in the company's disclosure controls and procedures, and investor relations personnel should ensure management's compliance with such controls and procedures.

Additionally, when companies are having meetings with analysts, they should consider informing the analysts of topics that will be off-limits, including previously released earnings guidance. In *Flowserve*, the SEC noted that Mr. Conley failed to do this.

Finally, the SEC in the *Flowserve* enforcement action considered Mr. Greer's and Mr. Conley's lack of cooperation with the SEC. Indeed, both Messrs. Greer and Conley denied that the reaffirmation had occurred, despite the company's own admission of that fact in its Form 8-K filing. While it is not clear how significant the lack of cooperation was in the SEC's action, the SEC affirmatively stated that it was a factor.

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