

CONFIRMATION OF EARNINGS GUIDANCE MAY BE A VIOLATION OF REGULATION FD

By L. Richards McMillan, II

The SEC announced on March 24, 2005 that it had settled charges against Flowserve Corporation, its CEO and its Director of Investor Relations for violating Regulation FD by reaffirming earlier earnings guidance in a private meeting with analysts. ([Click here to link to the full text of the SEC's order regarding the Flowserve proceeding.](#))

The following are the essential facts:

- At the beginning of 2002, Flowserve forecasted annual earnings per share of \$1.90 – \$2.30.
- In July 2002, it lowered the guidance to \$1.70 – \$1.90 per share.
- On September 27, 2002, it lowered the guidance again to \$1.45 – \$1.55 per share.
- In its Form 10-Q filed on October 22, 2002, it reaffirmed the \$1.45 – \$1.55 per share estimate.
- In response to a question at a private analyst meeting held on November 19, 2002, the CEO reaffirmed the estimate in the company's 10-Q; Flowserve's Director of Investor Relations remained silent.
- Flowserve had in place a formal policy for responding to questions about earnings guidance that required executives to state the following: "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."
- On November 20, 2002, an analyst who attended the meeting issued a report stating that Flowserve had reaffirmed its guidance.
- On November 21, 2002, Flowserve's stock closed up 6% on relatively high volume.

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- After the market closed on November 21, 2002, Flowserve filed a Form 8-K acknowledging that it had reaffirmed its guidance.

On the basis of the above facts, the SEC asserted a Regulation FD violation and obtained a consent judgment that included a cease-and-desist order and civil penalties against Flowserve and its CEO of \$350,000 and \$50,000, respectively.

This may seem a harsh result, given that the CEO simply confirmed at the analyst meeting what the company disclosed publicly only 30 days earlier. However, the result is consistent with the SEC Staff's view, expressed in the May 30, 2001 supplement to its telephone interpretation manual, that confirmation of a prior forecast may be material if the confirmation conveys additional information and the additional information is material. The following factors may have caused the Staff to view the Flowserve confirmation as material:

- The confirmation was given late in the fourth quarter, when preliminary results may have been known.
- The prior downward trend in guidance may have caused the market to expect more bad news, so that the confirmation was, in the context, more material than it might have been if the guidance had remained relatively consistent from the beginning.
- The company's stock price moved materially once the news was announced publicly, providing hindsight evidence of materiality.

It also seems likely that the Staff took two other factors into account:

- The confirmation violated the company's own published disclosure policy. A cardinal rule in this era of committee charters and website publication of corporate policies is: if you adopt them, you must follow them.
- The company apparently did not cooperate with the investigation to the extent the Staff thought was appropriate. Cooperation with an SEC Division of Enforcement investigation certainly carries risk, but so does not cooperating, as evidenced by the following

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excerpt from the SEC's March 24, 2005 press release regarding the Flowserve proceeding:

In addition to the underlying conduct, the Commission considered the Respondents' lack of cooperation afforded the Commission staff. Specifically, and inconsistent with the Form 8-K furnished by the Company, both Greer and Conley denied that a reaffirmation occurred at the private meeting with the analysts.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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