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Ruling on Disclosure of Wells Notices Under Federal Securities Laws

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Public companies have long faced a dilemma of whether and when to disclose the receipt of a Wells Notice from the Division of Enforcement Staff of the Securities and Exchange Commission. Until recently, companies had little formal, or even informal, guidance to consult. On one hand, the SEC had never brought an action in connection with the failure to disclose receipt of a Wells Notice, and no court had weighed in on whether a company has a duty to do so under the securities laws.

On the other hand, Regulation S-K, Item 103 provides that a public company must "[d]escribe briefly any material pending legal proceedings… known to be contemplated by governmental authorities." 17 C.F.R. §229.103. While a Wells Notice may signal an increased risk of an enforcement action in that it means the staff is likely to recommend that the commission vote to approve an enforcement action, the commission is solely responsible for initiating an enforcement action, not the staff, and has in some instances declined to approve the staff's recommendation.

In light of this uncertainty, companies historically have erred on the side of caution and have disclosed the receipt of Wells Notices to investors.

The Southern District of New York recently provided much needed clarity on this issue. In his June 21, 2012 decision in *Richman v. Goldman Sachs*, No. 1:10-cv-03461-PAC, 2012 WL 2362539 (SDNY June 21, 2012), Judge Paul Crotty held, in a case of first impression, that Goldman Sachs did not violate the federal securities laws by failing to disclose its receipt of Wells Notices in connection with the SEC's investigation of Goldman's sponsorship of a synthetic CDO transaction known as Abacus 2007-AC1.

In dismissing claims brought by a class of Goldman shareholders alleging that Goldman's failure to disclose the receipt of Wells Notices constituted actionable omissions under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, the court held that disclosure is not mandated under the federal securities laws until "the regulatory investigation matures to the point where litigation is apparent and substantially certain to occur." Id. at *6.

Recognizing the preliminary nature of a Wells Notice, the court found that receipt of a Wells Notice without more is "well short of litigation" and constitutes a "contingency" that Goldman was under no duty to disclose, pursuant to Regulation S-K or otherwise, because the receipt of such notice indicates, at most, "the desire of the Enforcement staff to move forward, which it has no power to effectuate" without formal approval by the commission. Id. at **4-5.

The Wells Process

Receipt of a Wells Notice is but one of several steps that typically occur on the path from the commencement of an investigation by the SEC Staff to the initiation of an enforcement action by the commission. Typically, the staff issues a Wells Notice and the prospective defendant prepares, in response, a Wells Submission, a progression known as the "Wells process" and codified in the SEC's procedural rules.[1] Through a Wells Notice, the staff informs the subject of an investigation that the staff has completed its investigation and is considering recommending an enforcement action to the commission.

> The 'Richman' decision rejected an affirmative duty, including under Regulation S-K, to disclose receipt of a Wells Notice.

The Wells Notice invites the subject to prepare a "Wells Submission," a statement that seeks to dissuade the staff from making such a recommendation to the commission, or seeks to convince the commission not to approve such a recommendation, by setting forth the prospective defendant's legal and factual arguments concerning a potential enforcement action. During and after the Wells process, the company may meet with members of the staff and, at the staff's discretion, hear about some of the facts and evidence obtained by the SEC.[2]

At this stage, neither the staff nor the commission has made a determination to recommend, much less proceed with, an enforcement action. Rather, "under [the Wells process], a prospective defendant or respondent enjoys due process" and is afforded an opportunity to be heard before the staff and the commission before any such decision is made.[3] Failing a change of heart by the staff, the commission meets in a closed meeting to hear the recommendation by the staff, and ask questions of the staff, before taking a vote on the recommendation. Even if the commission votes to proceed with an enforcement action, it is not uncommon for a subject to nevertheless avoid litigation through a negotiated settlement.

Abacus Investigation

In August 2008, the SEC first informed Goldman that it had commenced an investigation in connection with the Abacus transaction and served Goldman with a subpoena. Goldman received a Wells Notice on July 29, 2009, wherein the staff informed Goldman that it was considering a recommendation that the SEC bring an enforcement action and invited Goldman to provide a Wells Submission, which it did over two rounds of memoranda in September 2009. Goldman additionally met with the SEC on several occasions. Also in connection with the Abacus transaction, two Goldman employees received Wells Notices on Sept. 28, 2009, and Jan. 29, 2010, and both employees provided Wells Submissions to the staff.

On April 16, 2010, the SEC commenced an enforcement action against Goldman and one of the two employees, alleging that Goldman had misstated key facts by not disclosing the role that a hedge fund had played in the portfolio selection process and by not reporting that the hedge fund had taken a short position on the transaction through the purchase of CDS protection from Goldman. Without admitting or denying the allegations, Goldman settled the SEC action on July 14, 2010, for a payment of $550 million in penalties.[4] Also without admitting or denying any allegations, Goldman settled with FINRA on Nov. 9, 2010, for failing to timely report the Wells Notices, and paid a $650,000 fine.[5]

The 'Richman' Decision

On April 26, 2010, Ilene Richman filed a putative class action against Goldman, alleging violations of the federal securities laws (subsequently consolidated into the present action). Plaintiffs

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contended that Regulation S-K, Item 103, as well as FINRA and NASD rules, imposed an affirmative legal obligation on Goldman to disclose the receipt of the Wells Notices. Plaintiffs also asserted that, by not disclosing the receipt of the Wells Notices, Goldman's prior disclosures were rendered materially misleading as to the status of the investigation and the likelihood of formal charges.

Goldman moved to dismiss, and the court dismissed plaintiffs' claims arising out of the alleged failure to disclose the receipt of the Wells Notices (the court allowed other claims to survive not discussed here).

In evaluating whether Goldman's failure to disclose receipt of the Wells Notices constituted actionable omissions, the court relied on the standard set forth in a U.S. Court of Appeals for the Second Circuit decision, *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 360 (2d Cir. 2010): "An omission is actionable where (1) the omitted fact is material; and (2) the omission is (a) 'in contravention of an affirmative legal disclosure obligation,' or (b) needed 'to prevent existing disclosures from being misleading.'" 2012 WL 2362539, at *4. The court rejected plaintiffs' Wells Notice claims under the second prong of the test, holding that neither the regulatory framework nor Goldman's previous disclosures triggered a duty by Goldman to disclose the Wells Notices.

No Duty to Disclose

The court rejected plaintiffs' assertion that Goldman was under an affirmative legal obligation to disclose the receipt of the Wells Notices. First, the court rejected plaintiffs' argument that Regulation S-K, Item 103 required Goldman to disclose the Wells Notices. Again, Regulation S-K, Item 103 requires a company to "[d]escribe briefly any material pending legal proceedings…known to be contemplated by governmental authorities." 17 C.F.R. §229.103. As an initial matter, the court cautioned that "it is far from certain" that the reporting duties drawn from Regulation S-K suffice to create reporting duties under Section 10(b) and Rule 10b-5. 2012 WL 2362539, at *4.

The court proceeded to hold that Item 103 "does not explicitly require disclosure of a Wells Notice" and observed that "no court has ever held that this regulation creates an implicit duty to disclosure receipt of a Wells Notice." Id. at *6. The court further held, "[a]n investigation on its own is not a 'pending legal proceeding.'" Id. (citations omitted).

Moreover, reasoned the court, even receipt of a Wells Notice is "well short of litigation" because such a notice is only "an indication that the staff of a government agency is considering making a recommendation," and the advice of the staff "is not authoritative." Id. at *4. "[Section] 10(b) disclosure is mandated" held the court, only "[w]hen the regulatory investigation matures to the point where litigation is apparent and *substantially certain to occur*." Id. at *6 (emphasis added). According to the court, therefore, receipt of a Wells Notice is not mandated under Section 10(b) because "receipt of a Wells Notice does not necessarily indicate that charges will be filed." Id. at *4.

Second, the court also rejected plaintiffs' contention that FINRA and NASD rules impose regulatory reporting duties from which Section 10(b) claims can be based. FINRA Rule 2010 and NASD Conduct Rule 3010 require member firms to report an employee's receipt of a Wells Notice to FINRA within 30 days. While noting that violations of NASD rules (and Item 103) may be "relevant" to a 10(b) analysis, the court refused to allow plaintiffs to premise their securities fraud claims solely on Goldman's admitted violations of FINRA and NASD rules because "such 'rules do not confer private rights of action.'" Id. at *6 & n.6 (citation omitted).

Goldman's Earlier Disclosures

The court also rejected plaintiffs' argument that Goldman's earlier disclosures created a duty to disclose the receipt of the Wells Notices. Specifically, plaintiffs contended that Goldman made two sets of disclosures that were rendered misleading and incomplete by the receipt of the Wells Notices. First, in its 2008 Form 10-K, Goldman made the first of several disclosures that reported governmental investigations into its practices in connection with synthetic CDOs, disclosing that it had "received requests for information from various governmental agencies and self-regulatory organizations relating to subprime mortgages, and securitizations, collateralized debt obligations and synthetic products related to subprime mortgages."[6]

The 'Richman' court concluded, "[a]t best, a Wells Notice indicates not litigation but only the desire of the Enforcement staff to move forward, which it has no power to effectuate. This contingency need not be disclosed."

Second, in response to a Dec. 24, 2009, article in *The New York Times* that discussed regulatory and congressional scrutiny afforded to synthetic CDOs with a particular focus on Goldman,[7] Goldman published a one-page press release in which it provided an explanation of synthetic CDOs and the synthetic CDO market.[8] The press release did not address or mention the existence of governmental investigations, including the ongoing inquiry conducted by the SEC into the Abacus transaction.

Though the court agreed with plaintiffs that Goldman, by choosing to disclose the investigation, "has a 'duty to be both accurate and complete'"—even if it lacked an independent duty to disclose—the court stated that such disclosure "does not trigger a duty to reveal *all* facts on the subject, so long as 'what was revealed would not be so incomplete as to mislead.'" 2012 WL 2362539, at **4-5 (citation omitted; emphasis added). The court explained that the SEC filings were not made incomplete or misleading by the failure to disclose receipt of the Wells Notices because litigation at this point was not "substantially certain to occur" and "defendants are not bound to predict…the 'likely' outcome of the investigations." Id. at *5 (citations omitted).

Indeed, as acknowledged by the court, not only does the SEC Staff lack the ability itself to bring an enforcement action, the SEC did not bring an action against one of the two Goldman employees who had received Wells Notices. The court concluded, "[a]t best, a Wells Notice indicates not litigation but only the desire of the Enforcement staff to move forward, which it has no power to effectuate. This contingency need not be disclosed." Id.

The court also rejected plaintiffs' arguments with respect to the press release because Goldman's receipt of Wells Notices could not render a disclosure incomplete or misleading that made no mention at all of governmental investigations (much less a governmental investigation into synthetic CDOs).

Conclusion

Companies considering their reporting obligations now have guidance from this decision rejecting an affirmative duty, including under Regulation S-K, to disclose receipt of a Wells Notice. However, in its examination of Goldman's prior statements, the court did not categorically deny the materiality of Wells Notices but rather deemed the disclosures in this case to not have been rendered incomplete and misleading. Thus, the door may have been left open for claims brought in connection with different prior disclosures than those at issue in *Richman*. Accordingly, corporate counsel should continue to make disclosure determinations in connection with the receipt of Wells Notices on a case-by-case basis, particularly where the company already has made statements with respect to an investigation.

1. See 17 CFR §202.5(c).
2. SEC Enforcement Manual §2.4, available at http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.
3. Paul S. Atkins & Bradley J. Bondi, "Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program," 13 Fordham J. Corp. & Fin. L. 367, 383 (2008). However, a prospective defendant's right to submit a response to the Wells Notice is not absolute and the commission reserves the right to take any action prior to submission of a Wells Submission. Id. at 382 (citing Procedures Relating to the Commencement of Enforcement Proceedings and Termination of staff Investigation, SEC Release No. 33-5310, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶79,010, at 82183-86 (Sept. 27, 1972)).
4. Press Release, Securities and Exchange Commission, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), available at http://www.sec.gov/news/press/2010/2010-123.htm.
5. Press Release, Financial Industry Regulatory Authority, Goldman Sachs to Pay $650,000 for Failing to Disclose Wells Notices (Nov. 9, 2010), available at http://www.finra.org/Newsroom/NewsReleases/2010/P122416.
6. Goldman Sachs Group, Inc. 2008 Form 10-K at 42, available at http://www.goldmansachs.com/investor-relations/financials/archived/10k/docs/2008-10k-doc.pdf.
7. Gretchen Morgenson & Louise Story, "Banks Bundled Bad Debt, Bet Against It and Won," *N.Y. Times*, Dec. 24, 2009, at A1.
8. Press Release, "Goldman Sachs, Goldman Sachs Responds to the New York Times on Synthetic Collateralized Debt Obligations," Dec. 24, 2009, available at http://www.goldmansachs.com/media-relations/press-releases-and-comments/archive/index.html