Disclosure of Wells Notices Not Required by Section 10(b)

September 2012

A recent decision of the United States District Court for the Southern District of New York has held that Section 10(b) of the Securities Exchange Act of 1934 does not require companies to disclose their receipt of a Wells Notice.

The SEC provides the target of an investigation with a Wells Notice whenever the Enforcement Division staff decides, even preliminarily, to recommend charges. The party at risk of the enforcement action is then entitled to make a Wells submission presenting arguments why the Commissioners should reject the Enforcement Division staff's recommendation for enforcement. Many practitioners have used the receipt of a Wells Notice as a rule of thumb as to when funds should disclose to their investors the pendency of an SEC investigation.

This recent decision will lend support to the position that funds are not required by Section 10(b) to disclose the receipt of a Wells Notice or even the pendency of an SEC investigation. Of course, regulatory, contractual or other considerations may call for disclosure. Any fund that is contacted as part of a regulatory inquiry therefore should carefully consider with counsel whether disclosure to investors is appropriate in the circumstances.

In *Richman v. Goldman Sachs Group, Inc., et al.*, a class action pending in the United States District Court for the Southern District of New York, plaintiffs alleged, among other things, that Goldman and certain of its officers made material misstatements and omissions regarding Goldman's receipt of Wells Notices relating to its role in certain synthetic collateralized debt obligations. As alleged in the complaint, in August 2008, the SEC notified Goldman that it had commenced an investigation with respect to the CDOs and served Goldman with a subpoena. Goldman disclosed in its SEC filings that it had received requests for information and was cooperating with the requests. Almost a year later, on July 29, 2009 the SEC issued a Wells Notice to Goldman notifying it that the SEC Enforcement Division staff "intends to recommend an enforcement action" and providing Goldman with "an opportunity to respond concerning the recommendation." On September 28, 2009 and January 29, 2010, the SEC issued Wells Notices to two Goldman employees involved in the CDO transactions. On April 16, 2010, the SEC filed a complaint against Goldman and one of the two employees alleging securities fraud violations. Following the filing of the SEC complaint, the price of Goldman's stock dropped approximately 13%. The plaintiff in *Richman* filed her complaint shortly thereafter, on April 26, 2010, seeking to recover losses sustained by holders of Goldman stock as a result of Goldman's decision not to disclose the Wells Notices.

On July 14, 2010, Goldman reached a $550 million settlement with the SEC in which it acknowledged that its marketing material with respect to the CDOs was incomplete and that it had made a mistake in describing how the reference portfolio for the CDOs had been determined. On November 9, 2010, Goldman reached a $650 thousand settlement with FINRA in which Goldman admitted that it had violated NASD Conduct Rule 3010 (now FINRA Rule 2010) by failing to disclose within 30 days that its employees had received Wells Notices.

On Defendants' motion to dismiss the *Richman* complaint, the Court dismissed the claims for failure to disclose the Wells Notices. The Court started by noting that under Section 13 of the Exchange Act, Regulation S-K Item 103, a company is required to "describe briefly any material pending legal proceedings . . . known to be contemplated by governmental authorities." Rule12b-20 under the Securities Exchange Act of 1934 supplements Regulation S-K by requiring a person who has provided such information "in a statement or report ... [to] add[] such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading." While Regulation S-K does not apply to most funds, practitioners use it as a guide for disclosure obligations.

The Court cited cases describing the fact that Wells Notices, which are issued by the Enforcement Division staff, are "not authoritative" and noting that "the Wells process was implemented so that the Commission would have the opportunity to hear a defendant's arguments before deciding whether to go forward with enforcement proceedings." The Court then concluded, "Accordingly, receipt of a Wells Notice does not necessarily indicate that charges will be filed." "A Wells Notice may be considered an indication that the staff of a government agency is considering making a recommendation ... but that is well short of litigation."

The Court also addressed plaintiffs' claims that Goldman's previous disclosures regarding the investigation triggered a duty to disclose the receipt of the Wells Notices. The Court cited cases, however, stating that only "such [facts], if any, that are needed so that what was revealed would not be so incomplete as to mislead" must be disclosed. The Court noted that the SEC had commenced litigation against only one of the two Goldman employees to whom it had issued Wells Notices and held, "Defendants were not obligated to predict and/or disclose their predictions regarding the likelihood of suit." Defendants' prior disclosures did not require disclosure of the Wells Notices in order to prevent the prior disclosures from being inaccurate or incomplete, as "At 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."

Finally, while there was no dispute that Goldman violated FINRA Rule 2010 and NASD Conduct Rule 3010 by failing to disclose to FINRA its employees' receipt of Wells Notices, the Court noted that "Courts ... have cautioned against allowing securities fraud claims to be predicated solely on violation of NASD [now FINRA] rules because 'such rules do not confer private rights of action.'"

While the *Richman* opinion provides new guidance — and certainly questions the prior rule of thumb — it is not the end of the inquiry. First, the decision is from only a federal District Court.

The appellate court has not addressed the issue and, due to the procedure for appeals in the federal system, is not likely to do so soon if it does so at all. In addition, *Richman* addresses disclosure obligations under only Section 10(b) of the Exchange Act and Regulation S-K. Regulated entities may have other disclosure obligations, including under FINRA rules, when employees receive Wells Notices. Managers also have a general fiduciary duty under the Investment Advisers Act of 1940 to make "full and fair disclosure of all material facts." Further, entities which are regulated in foreign jurisdictions need to consider any applicable foreign regulatory requirements and securities laws which may have different triggers for disclosures. Also, contractual obligations for disclosure may exist in agreements and side letters, and investors may seek information about regulatory investigations in their due diligence questionnaires. Finally, if any disclosure previously has been made, care should be taken to be sure that developments do not require disclosure so that the statements previously will not be materially misleading.

It is important to involve counsel as soon as any regulatory inquiry is commenced. The issue of whether disclosure of the investigation should be made, and if so what the disclosure should be, needs to be discussed with counsel at every stage of the inquiry.

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