

Richman v. Goldman Sachs Group – Disclosure of Wells Notices

25 July 2012

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When a public company is notified by the SEC that the SEC has initiated an investigation of potential securities law violations by the company, the company must confront challenging disclosure issues. Should the commencement of the investigation be disclosed? When? In what matter, and in what detail?

These issues can be even more sharply posed when the company receives a “Wells notice” in connection with the investigation. After the SEC staff has investigated a matter and believes that a violation of federal securities laws has occurred, it will often issue a “Wells notice” to the company and individuals involved, informing them that the staff intends to recommend to the Commission that an enforcement action be commenced against the company for violation of the securities laws. The recipient of the notice has the opportunity to make a “Wells submission” to the SEC, making the company’s case as to why the proposed action should not be brought.

Prior to the receipt of a Wells notice, the company may believe that the staff will conclude after investigation that there is no basis for asserting that securities laws have been violated. Upon receipt of the Wells notice, however, the chances of an enforcement action being brought ordinarily will appear to have been raised significantly. As a result, in the past, public companies have often concluded that upon receipt of a Wells notice, the company should make public disclosure of this fact, including a description of the violations alleged in the notice.

The recent decision of the United States District Court for the Southern District of New York in *Richman v. Goldman Sachs Group, Inc., et al.*, 10 Civ. 3461 (June 21, 2012), the first reported decision squarely addressing the issue of a public company’s obligation to disclose receipt of a Wells notice, may now afford companies a basis for determining that disclosure of receipt of such a notice is not required.

The case involved an investigation commenced by the SEC in August 2008 into certain practices and disclosures engaged in by Goldman Sachs in connection with a synthetic

collateralized debt obligation transaction closed in 2007, in which investors had ultimately lost around \$1 billion. After Goldman's receipt of notice of the investigation and a subpoena, Goldman disclosed in its SEC filings 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 relating to subprime mortgages," and that Goldman was "cooperating with the requests." According to the opinion, this disclosure first appeared in Goldman's 10-K for 2008, filed January 27, 2009.

On July 29, 2009, the SEC issued a Wells notice to Goldman, notifying Goldman that the Enforcement Division staff intended to recommend an enforcement action, and providing Goldman with an opportunity to respond concerning the recommendation. On September 10 and September 25, 2009, Goldman provided its Wells submissions to the SEC and thereafter engaged in numerous meetings and discussions with the SEC. On April 16, 2010, the SEC filed an enforcement action against Goldman (presumably publicly disclosed either by the SEC or Goldman, or both, although the opinion does not make this clear), at which time Goldman's stock dropped approximately 13 percent. The case was ultimately settled for \$550 million.

Goldman never disclosed its receipt of the Wells notice. Plaintiffs alleged this failure constituted a violation of section 10(b) of the Exchange Act and Rule 10b-5. Goldman moved to dismiss the complaint on the grounds that plaintiffs failed to plead an actionable misstatement or omission.

The court granted Goldman's motion to dismiss. (Other aspects of plaintiffs' complaint were not dismissed; these are beyond the scope of this memorandum.)

The court first analyzed the disclosure requirements imposed by Item 103 of Regulation S-K with regard to pending or threatened litigation. These requirements would have been applicable to each 10-Q and 10-K filed by Goldman after its receipt of the Wells notice, and a failure to comply with the requirements would support a claim that the omission was actionable in a private action under section 10(b) and Rule 10b-5. Under Item 103, a company is required to describe any "material pending legal proceedings" "known to be contemplated by governmental authorities." In the court's view, the whole point of the issuance of a Wells notice is to provide the SEC with an opportunity to hear a defendant's position before determining whether to bring an action. The process recognizes that the staff's advice on the matter is not "authoritative." Thus, receipt of a Wells notice does not necessarily indicate that litigation will be commenced. The court stated that while a Wells notice may be an indication that the staff of the agency is considering making

a recommendation to the agency to bring an action, “that is well short of litigation.” An investigation, held the court, is not a “pending legal proceeding” unless it reaches a stage when the agency or prosecutorial authority makes known that it is contemplating filing suit or bringing charges.

The court noted that no court had ever held that a company’s failure to disclose a Wells notice constituted an actionable omission under section 10(b) or Rule 10b-5.

Thus, in this case, where as is customary the Wells notice indicated only that the staff was contemplating (but had not as yet made) a recommendation to the Commission that an action be commenced, and where the Commission had taken no action on the matter, the possible proceeding that might or might not be commenced in the future was not at that point a “material pending legal proceeding” “known to be contemplated by governmental authorities,” and thus was not required to be disclosed under S-K Item 103. Although not expressly stated by the court, the reasoning indicates that either (i) the staff intention to recommend an enforcement action to the Commission (giving rise to the issuance of the Wells notice) was not a “contemplation” of a legal proceeding, or (ii) if it was a contemplation of a legal proceeding, it was not contemplation by “governmental authorities” within the meaning of Item 103, the staff evidently not being a “governmental authority” for this purpose. And, at the point of receipt by the company of the Wells notice, the Commission itself could not be said to be “contemplating” legal action. So characterized, this decision could well be relied upon in other situations, particularly since it was not based on any assessment by the court of the magnitude of the potential financial impact of the matter upon the company, a matter likely to differ greatly from case to case.

In addition, the court addressed claims that, aside from the express requirements of S-K Item 103, Goldman’s failure to disclose receipt of the Wells notice was actionable because such disclosure was necessary to make other statements made by Goldman in the relevant period not misleading. The court characterized plaintiffs’ argument as follows: Goldman’s disclosures in its SEC filings about governmental investigations triggered a duty to disclose Goldman’s subsequent receipt of the Wells notice, and by failing to make such disclosure, Goldman misled the public into erroneously concluding that no significant developments had occurred that made the investigation more likely to result in formal charges.

The court agreed that under section 10(b) and Rule 10b-5, when a corporation chooses to speak, even where it lacks a duty to speak, it has a duty to be both accurate and complete. However, the court held, the disclosures that were made about the existence of an investigation did not necessitate disclosure of the Wells notice. Disclosure of the Wells notice, the court held, was not necessary to prevent the disclosures concerning the existence of an investigation from being materially misleading. At best, the court stated, 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.”

It bears emphasis that the disclosure framework presented in this case reflected an initial generalized disclosure of the commencement of an investigation. It is not clear how heavily the decision could be relied upon to justify nondisclosure of receipt of a Wells notice where no disclosure whatsoever had been made about an investigation. Also, there may be public relations or other reasons for determining to make disclosure of a Wells notice. Or, if the company is at the time of receipt of the Wells notice engaged in a distribution or repurchase of its securities, that may reduce the precedential value of the decision.

However, as a decision by a court that is highly respected in federal securities matters and that involves a high-profile party, this case may in appropriate circumstances afford a company a degree of comfort previously unavailable in determining not to make public disclosure of receipt of a Wells notice.

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