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Court Holds a Wells Notice Does Not Trigger an Automatic Disclosure Obligation for Public Companies

United States District Judge Paul Crotty, sitting in the Southern District of New York, has issued a ruling holding that a public company did not have a duty, upon which a federal securities fraud claim could be based, to disclose the receipt of a Wells Notice from the Securities and Exchange Commission (SEC or Commission).[1] A Wells Notice is a notice to the recipient that the staff of the SEC's Division of Enforcement (SEC staff) intends to recommend that the Commission pursue an enforcement action against the recipient. Under SEC Rules, in response to such a notice, the recipient is entitled to make a Wells submission presenting facts and argument as to why the SEC staff should not make such a recommendation.[2] If the staff decides to goes forward with its recommendation, the Commission will review the recommendation and the Wells submission, and decide whether to authorize an enforcement proceeding. Accordingly, receipt of a Wells Notice does not necessarily indicate that charges will be filed.

In the current regulatory climate, public reporting companies are increasingly faced with the difficult question of whether to disclose the existence of a governmental investigation and subsequent receipt of a Wells Notice. Even though a Wells Notice may not be followed by an enforcement proceeding, disclosing a Wells Notice can cause a company's brand and its stock to be negatively impacted. The significance of a Wells Notice depends on many factors, including the nature of the SEC's allegations and a company's possible defenses. Balancing the desire to avoid unnecessary harm to the company and its shareholders with the need to comply with disclosure obligations can be a difficult task. The guidance in this regard has not been clear, and public companies often seek to avoid compounding regulatory problems by erring on the side of early, complete disclosure. Judge Crotty's decision holds that a public company does not have a duty to disclose the existence of a governmental investigation until "litigation is apparent and substantially certain to occur." Moreover, receipt of a Wells Notice, which "indicates not litigation, but only the desire of the enforcement staff to move forward," likewise does not automatically trigger a disclosure obligation.

Disclosure Obligations

"Silence, absent a duty to disclose, is not misleading" under the federal securities laws.[3]

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1 *Richman v. Goldman Sachs Group, Inc.*, No. 10-3461 (June 21, 2012) ("*Richman*"). This memorandum addresses only the court's holding concerning the defendant's duty to disclose a Wells Notice, and does not discuss unrelated aspects of the opinion.

2 *See* Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No. 5310, Exchange Act Release No. 9796, Investment Company Act Release No. 7390 [1972-1973 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 79,010 at 82,183-86 (Sept. 27, 1972).

3 *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

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The securities laws do not require disclosure of every fact — even facts that may be material to investors. An issuer is under no duty to disclose a specific material fact except where disclosure: (1) is dictated by a specific statute or regulation; (2) would be necessary to render what is disclosed not misleading; or (3) when the issuer is trading in its own stock.[4]

Item 103 of Regulation S-K, promulgated under Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act"), requires public companies to "describe briefly any material pending legal proceedings...known to be contemplated by governmental authorities."[5] FINRA Rule 2010 (formerly NASD Conduct Rule 3010) explicitly requires financial firms to report a registered employee's receipt of a Wells Notice to FINRA within 30 days.

In addition to affirmative obligations to disclose, public companies are required to make disclosures necessary to prevent existing disclosures from being misleading. Thus, an issuer may have a duty to disclose the existence of a governmental investigation or the receipt of a Wells Notice if the issuer's prior statements would be rendered inaccurate or incomplete without such a disclosure.

Issuer Had No Affirmative Regulatory Duty to Disclose Receipt of Wells Notice

In the case before him, Judge Crotty soundly rejected plaintiffs' argument that there was an affirmative duty for the company to disclose the receipt of Wells Notices directed to it and to two of its employees, under Regulation S-K Item 103, FINRA, and NASD Rules. The court held that under Regulation S-K, Item 103, a governmental investigation, even one in which a Wells Notice has been issued, does not rise to the level of a "pending legal proceeding." The court explained that although a Wells Notice "may be considered an indication that the staff of a government agency is considering making a recommendation" to institute a legal proceeding, such a notice is "well short of litigation." Until an SEC investigation "matures to the point where litigation is apparent and substantially certain to occur...disclosure is not required." In so holding, the court made note of the fact that "no court has ever held that [Regulation S-K Item103] creates an implicit duty to disclose receipt of a Wells Notice."

In addition, the court held that the plaintiff shareholders could not sue the company for violating Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, based solely on violations of FINRA Rule 2010 and NASD Conduct Rule 3010, given that such rules do not confer private rights of action.

Issuer's Prior Disclosures about Governmental Investigations Did Not Trigger a Duty to Disclose Receipt of Wells Notice

The court also rejected plaintiffs' argument that the company's existing disclosures triggered a duty to disclose its subsequent receipt of a Wells Notice. The company had disclosed that there were governmental investigations pending into certain of its business practices, but did not update its disclosures when it received a Wells Notice from the SEC staff. The plaintiffs argued that by failing to disclose that the government inquiries resulted in a Wells Notice, the company misled the public into concluding that "no significant developments had occurred which made the investigation more likely to result in formal charges."

The court noted that the plaintiffs did not, and could not, allege that the Wells Notice indicated that litigation was substantially certain to occur. "At best," the court held, "a Wells Notice indicates not litigation but only the desire of the Enforcement staff to move forward,

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[4] *See, e.g., In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 360 (2d Cir. 2010); *Backman v. Polaroid Corp.*, 910 F.2d 10, 20-21 (1st Cir. 1990). This memorandum discusses only the first two situations, as the third was not an issue in *Richman.*

[5] 17 CFR § 229.103. Mutual funds have a disclosure obligation similar to Regulation S-K Item 103. In its registration statement, a mutual fund must describe "any material pending legal proceedings...to which the Fund or the Fund's investment advisor or principal underwriter is a party," including "any proceeding instituted by a governmental authority or known to be contemplated by a governmental authority." Legal proceedings are material if "they are likely to have a material adverse effect upon: (1) the ability of the investment adviser or principal underwriter to perform its contract with the Fund; or (2) the Fund." Form N-1A, *available at* http://www.sec.gov/about/forms/formn-1a.pdf; *see also* Form N-2, *available at* http://www.sec.gov/about/forms/formn-2.pdf. Investment advisers must disclose a "legal or disciplinary event...material to a *client's* or prospective *client's* evaluation of [its] advisory business or the integrity of its management." Form ADV, *available at* http://www.sec.gov/about/forms/formadv.pdf (emphasis in original).

which it has no power to effectuate." Thus, the company's receipt of the Wells Notice signaled only that "governmental investigations were indeed ongoing," which was consistent with the company's disclosing the existence of the investigations. The court also made clear that "a corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact." Corporations are "not obligated to predict and/or disclose their predictions regarding the likelihood of suit," and a Wells Notice is a "contingency [that] need not be disclosed."

The court similarly found that a press release issued by the company that dealt with the type of securities that were the subject of the Wells Notice did not trigger a duty to disclose the notice. The court held that "revealing one fact about a subject matter 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." Because the press release merely discussed how the securities worked and why they were created, and did not mention the existence of government investigations, it "contained nothing concerning the investigations that could be considered inaccurate or incomplete."

Conclusion

Despite the current regulatory environment, Judge Crotty's decision makes clear that issuers should not assume that they are obligated to disclose a pending governmental investigation or subsequent receipt of a Wells Notice. Such a duty may arise depending on the facts and circumstances surrounding the investigation and the issuer's prior statements relating to such an investigation; however, a disclosure obligation should not be axiomatic. While any disclosure decision must be based upon the facts and circumstances of each case, companies in the midst of an offering of securities may want to err on the side of caution and disclose receipt of a Wells Notice notwithstanding the holding of *Richman*.

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