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Court Finds No Duty To Disclose SEC Wells Notice

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In an important case deciding for the first time a disclosure issue public companies frequently confront, a federal judge has ruled that, standing alone, a company's failure to disclose that it received a Wells notice from the SEC enforcement staff is not enough to plead a private securities fraud action under the Securities Exchange Act of 1934. Although Judge Paul A. Crotty's decision in *Richman v. Goldman Sachs Group, Inc.*, No. 10-3461 (S.D.N.Y.), is likely not the last word on this issue, it is a persuasive and thoughtful articulation of the view that there is—and should be—no generalized, affirmative duty to disclose the receipt of a Wells notice, even where a registrant has made prior disclosures regarding the fact that it is under investigation. Judge Crotty's holding in this context that disclosure of threatened litigation is only required once "litigation is apparent and substantially certain to occur" is a similarly helpful clarification of the law.

The *Richman* Decision

The plaintiffs in *Richman* sued Goldman (and three of its officers) for securities fraud under Section 10(b) of the Exchange Act, claiming that Goldman had fraudulently failed to disclose that it had been served with a Wells notice in connection with an SEC investigation into the so-called "Abacus transaction." According to the complaint, in August 2008 the SEC enforcement staff commenced an investigation of Goldman relating to the Abacus transaction, and Goldman disclosed in its securities 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." The SEC staff issued a Wells notice to Goldman in July 2009, which allegedly notified Goldman that the SEC enforcement staff "intend[ed] to recommend an enforcement action" and provided Goldman "with an opportunity to respond concerning the recommendation." According to the complaint, Goldman did not disclose that it had received a Wells notice, nor did it disclose that two of its employees had also received Wells notices.

Plaintiffs asserted that Goldman's failures to disclose the Wells notices made its prior disclosures about the investigation misleading and that Goldman had an affirmative obligation to disclose the Wells notices under various SEC regulations and FINRA rules. Judge Crotty carefully considered and rejected these claims, holding that, under the circumstances, Goldman had no obligation to provide additional information about the status of the SEC's investigation.

Wells Notices Are Merely an "indication that the staff of a government agency is considering making a recommendation"

Judge Crotty began by describing in detail the nature of a Wells notice and the accompanying regulatory framework, emphasizing that such notices are sent when the SEC's enforcement staff decides "even preliminarily, to recommend charges." The recipient is entitled to respond in writing and to "present [ ] arguments why the Commissioners should reject the . . . staff recommendation." As Judge Crotty correctly noted, the entire Wells process is predicated on the "recognition that staff advice is not authoritative" and 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." Judge Crotty concluded that, at most, a Wells notice is an "indication that the staff of a government agency is considering making a recommendation," but such a recommendation is "well short of litigation." He also emphasized that "no court has ever held that a company's failure to disclose receipt of a Wells Notice constitutes an actionable omission under § 10(b) or Rule 10b-5."

No Duty To Disclose Wells Based on Prior Disclosures; No Duty To Predict Outcome of Investigation

Against this backdrop, Judge Crotty first held that Goldman had no duty to provide ongoing information about its receipt of Wells notices because its silence did not render its prior statements regarding the investigation misleading. Judge Crotty emphasized that a corporation is not required to predict whether an investigation will result in an enforcement action, and noted in this regard that one of the employees who received a Wells notice was never charged. He also reiterated that providing accurate information does not require a company to "reveal all facts on the subject" so long as what was provided is not so incomplete as to be inaccurate. In the end, Judge Crotty held that a duty to disclose only arises once "litigation is apparent and substantially certain to occur," and that the mere receipt of a Wells notice did not satisfy this test.

No Duty To Disclose Based on Regulation S-K or FINRA Action

Judge Crotty similarly rejected plaintiffs' argument that Goldman had a duty to disclose the Wells notices pursuant to various regulations. Judge Crotty specifically noted that Item 103 of SEC Regulation S-K does not explicitly require disclosure and that no court has ever so construed the regulation. Judge Crotty also rejected arguments that disclosure was required based on the fact that FINRA had sanctioned Goldman for its failure to disclose the Wells notices received by its *employees*. He emphasized that courts have "cautioned" against allowing "securities fraud claims to be predicated solely on violations of [FINRA] rules because such rules do not confer private rights of action."

Disclosure Implications for Registrants

Judge Crotty's decision is strong support for the proposition that there is no generalized duty—either in federal common law or pursuant to SEC or other regulation—to disclose a Wells notice. Nevertheless, we stress that, by carefully examining whether the failure to disclose the Wells notice might somehow have rendered other statements misleading, Judge Crotty left the door open for the possibility that, under certain circumstances, a company might need to disclose a Wells notice. For example, a disclosure decision might be more difficult if prior disclosures made optimistic statements regarding the likely outcome of the investigation. Such situations, however, should be quite rare given current corporate disclosure practices, so the *Richman* rationale should apply in most circumstances.

The *Richman* decision is also noteworthy because it confirms that a violation of FINRA rules is not usually sufficient, on its own, to plead a private securities fraud claim. The FINRA action discussed in *Richman* was based on Goldman's failure to comply with specific requirements relating to FINRA Form U4.[1] Form U4 mandates that registered persons identify within thirty days whether they have been notified in writing that they are the "subject of any . . . investigation." The FINRA action against Goldman asserted that Goldman did not have appropriate supervisory processes in place to

ensure that compliance personnel were timely notified of Form U4 reportable events. Although the ultimate rationale for requiring such notifications is to enable securities regulators, potential employers, and the public to make an informed judgment about the conduct of registered persons, *see* FINRA Letter of Acceptance, Waiver and Consent No. 2010 022-4738-01, at 3, Judge Crotty did not delve into these issues. Instead, he simply relied on general principles disfavoring the use of regulatory provisions to plead private securities fraud actions.[2]

1 Form U4 contains information on individual registered persons and is part of the Central Registration Depository.

2 The individual employees who received Wells notices were not named as defendants in *Richman*. Thus, Judge Crotty had no reason to consider whether an individual's failure to disclose a Wells notice might offer better support for a securities fraud claim.

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