Securities Litigation Client Alert

District Court First To Say That There Is No Obligation to Disclose SEC Wells Notice

by Larry P. Ellsworth

In a case of first impression, the District Court for the Southern District of New York on June 21, 2012, dismissed a class action claim that Goldman Sachs (Goldman) committed securities fraud by failing to disclose that it had received from the Securities and Exchange Commission (SEC) a Wells Notice indicating that the staff intended to recommend that the SEC bring an action against Goldman for alleged fraud in connection with Goldman's Abacus Synthetic collateralized debt obligations. At the same time, the court refused to dismiss the class action claim that the Abacus debt obligation transaction itself was fraudulent. *Richman v. Goldman Sachs Group, Inc.*, Case No. 1:10-cv-03461-PAC (S.D.N.Y., June 21, 2012).

The issue of whether a Wells Notice must be reported has long been a difficult question, generally addressed by securities counsel on a case-by-case, facts-and-circumstances basis. This judicial decision regarding a private action may affect those analyses in the future. To date, we have identified no actions brought by the SEC for failure to disclose the existence of either a SEC investigation or a Wells Notice.

The Regulations

SEC Regulation S-K, Item 103, requires that a company in its quarterly and annual reports:

Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party …. Include similar information as to any such proceedings known to be contemplated by governmental authorities. [17 C.F.R. 229.103]

Rules 12b-20 and 408 also require "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."

The Court's Analysis

The plaintiffs alleged that: (1) Goldman had a duty to disclose the receipt of a Wells notice, and (2) even without a general duty to disclose, Goldman had to disclose the Wells Notice here in order to prevent the initial disclosure that there was only a pending SEC investigation from being misleading. The District Court rejected each allegation.

On the first issue, the court held that there was no general, regulatory duty to disclose a Wells Notice. Nothing in Regulation S-K, Item 103, explicitly mandates such disclosures and no court had ever required it. Since the staff's recommendation did not indicate that "litigation ... was 'substantially certain to occur,'" language taken from another Southern District opinion, *In re Citigroup, Inc. Securities Litigation,* 330 F. Supp.2d 367, 377

(SDNY 2004), *aff'd, subnom. Albert Faden Trust v. Citigroup, Inc.,* 165 F. App'x 928 (2d Cir. 2006), the Wells Notice was not required by Regulation S-K. The court did not specifically address the language of Regulation S-K, Item 103, requiring disclosures of "proceedings known to be contemplated by governmental authorities." But the court stated that, in any event, "[i]t is far from certain that … a duty to disclose under Rule 10b-5 may be satisfied by importing disclosure duties from [an] S-K [regulation]." Slip op. at 11 (quoting *In re Canandaiga Secs. Litig.*, 944 F. Supp. 1202, 1210 n.4 (S.D.N.Y. 1996)). Similarly, the court indicated that a FINRA requirement, indisputably violated by Goldman, to disclose within 30 days any Wells Notice to any of its employees is not imported to Rule 10b-5 because there is no private right of action arising from FINRA regulations. *Id.*

Regarding the second issue, the court concluded on these facts that the plaintiffs had "not shown that Defendants' nondisclosure of their receipt of Wells Notices made their prior disclosures … materially misleading." The court reasoned that plaintiffs had not alleged that "litigation was substantially certain to occur," and stated that the company is neither required to predict or disclose the "likelihood of suit" nor "to disclose a fact merely because a reasonable investor would very much like to know that fact." The disclosure that there was an ongoing SEC investigation remained accurate even after the SEC staff gave its Wells Notice.

Finally, the court stated that in any event the plaintiffs had failed to adequately plead scienter since defendants' "failure to disclose [their receipt of Wells Notices], by itself, can only constitute recklessness if there was an obvious duty to disclose that information." [Citation omitted]. Here, the court held, the duty to disclose was not "obvious," a point which will be much stronger in the future in view of this court's decision.

Conclusion

While companies should continue in each case to seek advice of competent securities counsel on disclosure issues, such as those raised when a Wells Notice is issued, this case makes it less likely that a successful, private securities action can be mounted solely on the basis of a decision not to disclose receipt of a Wells Notice from the SEC. But the decision is that of only one court and the facts and circumstances in each situation should be carefully weighed with securities counsel before finalizing a disclosure decision.

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