

# **When the SEC Calls**

## **Handling Disclosure and Investor Relations Issues Related to SEC Comment Letters, Inquiries and Investigations**

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# Why Might the SEC Be “Calling”?

## The Three Common Reasons:

- **Comment Letter from the SEC's Division of Corporation Finance**
- **Informal Inquiry from the SEC's Division of Enforcement**
- **Formal Investigation from the SEC's Division of Enforcement**

# The SEC Comment Letter

# Genesis of the SEC Comment Letter

- Sarbanes-Oxley requires that the SEC review and comment on periodic filings of every public company at least every three years.
- SEC also often will review and comment on filings if certain types of events are reported, such as:
  - Restatements
  - Material weaknesses in internal controls
  - Impairments

# The SEC Comment Letter Process

- Company will receive a written letter from the SEC with questions regarding its public filings.
- This SEC comment letter is publicly available.
- Company will respond in writing with assistance of external legal counsel and independent auditor, if needed.

# Confidential Treatment of SEC Comment Letter Responses

- Company can request confidential treatment for all or portions of its responses to the SEC under a Rule 83 request.
- Company also can request return of confidential materials under Rule 418(b) of the Securities Act of 1933 or Rule 12b-4 of the Securities Exchange Act of 1934.

# What Should be the IR Professional's Role in the Comment Letter Process?

- The Comment Letter is public and the responses may also be, so IR professional should be actively involved.
- IR professional should assist in analyzing whether confidential treatment of information should be requested:
  - often IR professional is person most aware of whether information was already public.
  - shareholders and analysts often question why information in response to Comment Letter was kept confidential.
- IR professional should analyze whether any comments or responses are likely to generate interest from third parties (media, analysts, investors, etc.) and prepare appropriate responses.



# The SEC Informal Inquiry

# What is an Informal Inquiry?

- The SEC asks a company to voluntarily provide information and documents to the SEC relating to certain topics. The SEC cannot issue subpoenas or compel testimony.
- Historically, almost always a precursor to a formal investigation.
- Recently, power tends to be overused by the SEC, questioning whether an informal inquiry should be considered a material event.
- SEC guidance indicates that “cooperation” of company in informal inquiry can help deter a formal investigation.

# Is there a Duty to Disclose the Commencement of an Informal Inquiry?

- **DreamWorks v. Pixar Approach:**
  - Both faced informal inquiries regarding sales of DVDs (PR said sales were wonderful, SEC filings more realistic).
  - DreamWorks disclosed in Form 8-K and next Form 10-Q. Pixar did not.
  - Story picked up by WSJ in August 2005. Pixar then added disclosure in next 10-Q.

# Disclosure

- **DreamWorks:** “In July 2005, we announced that we had received a request from the staff of the SEC and are voluntarily complying with an informal inquiry concerning trading in our securities and the disclosure of our financial results on May 10, 2005. The SEC has informed us that the informal investigation should not be construed as an indication that any violations of law have occurred. We are cooperating fully with the inquiry.”
- **Pixar:** “*Informal Inquiry by the SEC.* The Company has received an informal inquiry from the SEC requesting information regarding the disclosure of its second quarter financial results. The Company is cooperating fully with the inquiry.”

# When Should a Company Disclose that an Informal Inquiry is Underway?

- There is no specific line-item requirement to disclose the existence of an SEC investigation.
- The obligation to make disclosure is a materiality analysis.

# Factors to Weigh

- What is the likely impact of the inquiry on the company's financial performance and prospects?
  - Costs of cooperating / defending.
  - Impact on ability to retain/gain customers and ability to access capital markets
- What is the likelihood that inquiry will result in a formal investigation or enforcement action?
- What is the impact that a potential enforcement action would have on the company?

# Even If Not Material, Consider Voluntary Disclosure

- Disclosure may reduce exposure of company to liability in private litigation (e.g., others may deem it material).
- Analyst, investor or media rep may ask company if it is the subject of an investigation and disclosure may be preferable to “no comment.”
- SEC may contact third parties (customers, vendors, etc.) regarding inquiry.
- Avoids company officials feeling need to address “rumors.”

# Reasons Not to Voluntarily Disclose Non-Material Inquiry

- Announcement will likely:
  - Result in adverse publicity
  - Negatively impact stock price
  - Attract the attention of plaintiff's bar
  - May put pressure on SEC to pursue enforcement action
  - Negatively impact company relationships (customers, creditors, vendors, investors, analysts, etc.)
- In addition, many informal inquiries are resolved without any enforcement action.



# Will the SEC Make the Informal Inquiry Public?

- Typical practice is for the inquiry to be on a “non-public” basis.
- SEC’s practice is to refuse to confirm or deny publicly that an informal inquiry is taking place.
- **HOWEVER**, SEC may contact third parties, such as customers, suppliers, creditors and analysts, and correspondence will usually reference the issuer’s name.
- Company should use Confidential Treatment Request process of Rule 83 to make sure all written communications and documents produced to SEC are kept confidential.

# If Decisions to Disclose is Made, Where Should Disclosure be Made?

- Various practices:
  - Press release with Form 8-K filing
  - Form 8-K filing only
  - Disclosure in next periodic report, including risk factor addition
- Consider whether it is likely that inquiry will be kept confidential (how many employees know, outside advisors, etc.).

# What Should be Disclosed?

- There is pressure to make extensive disclosure to satisfy media, analysts and investors.
- However, balance this against potential legal exposure:
  - Avoid blanket denials, which could lead to exposure if restatement or enforcement action results.
  - More extensive means more likely a need to update disclosure as facts change.
  - Updated disclosure means another round of adverse publicity.
  - Detailed disclosure helps plaintiff's bar draft its complaint.
  - Danger that privileges could be waived.

# Additional Disclosure Concerns

- Be aware that if outside PR consultants (other non-legal consultants) are used to assist with disclosure, attorney-client privilege will be waived.
- Also, keep in mind that analysis of Regulation FD selective disclosure should be done.

## **Make Sure that Company Officials:**

- Are briefed on company position for press inquiries (conference call scripts are essential).
- Do not falsely deny existence of inquiry if questioned.
- Do not speculate on unknowns such as focus of SEC inquiry, source of inquiry or length of inquiry.
- Do not make negative public comments about the SEC.

# The SEC Formal Investigation

# What is a Formal Investigation?

- The SEC commissioners have issued an order, known as a “Formal Order,” authorizing the SEC staff to issue subpoenas to require production of documents and provision of testimony.
- Formal Order is not generally available to public, but a copy usually is given to anyone testifying or producing documents.
- The SEC generally does not announce formal investigations.

# Does a Formal Order Mean Enforcement Action is Coming?

- No – the SEC closes many formal investigations without any enforcement action. It can mean many other things:
  - The SEC has identified an issue that warrants further investigation.
  - The SEC has not viewed the company as cooperative in an informal inquiry.
  - The SEC feels it needs subpoena power to elevate either cooperation of company or to use to compel third parties to cooperate.



# When Should a Company Disclose that a Formal Investigation is Underway?

- As with an informal inquiry, there is no specific line-item requirement to disclose the existence of an SEC investigation.
- The obligation to make disclosure is a materiality analysis – the same factors should be considered.
- So analysis and concerns remain the same as with an informal inquiry, but a company is more likely to decide that formal investigation is material and hence disclosable.

# The SEC Enforcement Action

# How does an Enforcement Action Result?

- The SEC Staff recommends to the SEC commissioners to institute an enforcement proceeding. Before this recommendation occurs, the SEC Staff usually issues a “Wells Notice” to any perspective defendants.
- Perspective defendants can then prepare a document called a “Wells Submission” to try to persuade the Staff that an enforcement action is unnecessary. Many potential defendants do not do Wells Submission because:
  - It is not privileged.
  - It is not confidential.
  - It can be used factually against the company.

# Does Wells Notice Trigger Disclosure Requirement?

- Again, there is not a line item disclosure – this is a materiality analysis. Most companies report the Wells Call notice in a press release that is filed on Form 8-K.
- If enforcement action results, the SEC will issue press release

# Conclusion – Cooperation is Key, But May Not Be Enough

# Some Final Pointers

- The IR professional is in perhaps the most difficult position in a company and must balance:
  - Informing the public, against
  - Exposing the Company to potential liability.
- Don't jump to respond quickly and don't jump to disclose prematurely.
- Make sure you get informed on issues. The instinct is to protect the company, but don't assert facts without investigation or proof.