

# Disclosures of SEC Investigations Resulting in Wells Notices

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Cornerstone Research has conducted a study of the market reaction to company disclosures of receipt of a Wells notice from the Securities and Exchange Commission (SEC). Our findings indicate that, when analyzed collectively, the announcement of a Wells notice on average is associated with a statistically significant market-adjusted stock price decline. Analyzed individually, however, only 17 of 58 disclosures of Wells notices between April 2002 and January 2007 were associated with statistically significant market-adjusted stock price declines, indicating that market participants discern firm-specific differences across announcements of receipt of Wells notices.

Moreover, disclosures of an informal investigation or a formal investigation prior to the receipt of the Wells notice resulted on average in negative, statistically significant stock price movements. However, there was no significant difference between the average market-adjusted returns on the day of the disclosure of receipt of a Wells notice for investigations that had been previously disclosed and the market-adjusted returns related to those that had not. These findings are consistent with the hypothesis that market participants perceive the disclosure of an informal or formal investigation as a signal of a higher likelihood that the outcome of the investigation will have a material impact on the company relative to announcing only the receipt of a Wells notice. Otherwise, one would expect the disclosure of the Wells notice that was the first disclosure of the investigation to result in a larger negative price movement than disclosures that followed prior announcements of the investigation. Also consistent with this hypothesis is the finding that investigations disclosed prior to the Wells notice were more likely to result in a fine being imposed on the target company or individual than investigations that were only disclosed at the Wells notice stage.

## Historical Trends and Timing of Investigations

From 1997 through 2002 (fiscal year ending September 2002), the SEC initiated between 408 and 570 new investigations each year. As shown in figure 1, following the Enron and WorldCom investigations and the passage of Sarbanes-Oxley (July 30, 2002), the SEC initiated new investigations at nearly twice the previous annual rate. Although new investigations dipped in fiscal year 2007, they rose again in fiscal year 2008.

New investigations are typically “informal” in nature.

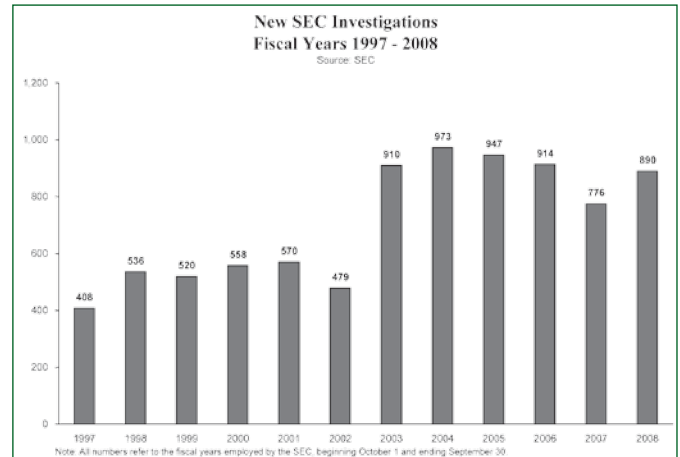


FIGURE 1

If, after an initial review, the commission deems that a violation of the federal securities laws “may have occurred or may be occurring,”<sup>1</sup> it may issue a “formal order of investigation.” Such an order empowers the staff to, among other things, subpoena witnesses and compel the production of documents. When the formal investigation is substantially complete, if the SEC is considering filing an action in court or an internal administrative proceeding, a Wells notice generally follows.<sup>2</sup> Recipients of a Wells notice are typically accorded the opportunity to provide a voluntary statement—a Wells submission—arguing why the commission should not bring an action against them.<sup>3</sup> Subsequent steps in the investigation may include termination of the investigation, settlement, court action, or an internal administrative proceeding.

The SEC does not publicly comment on particular investigations until it files an action in court or in its internal administrative process. Prior to such a filing, public disclosure of the investigation is at the discretion of the target company. To identify Wells notice disclosures, we conducted a search of company SEC filings in the EDGAR database for the years 1997–2007, excluding disclosures concerning mutual funds. Our search yielded no Wells notice disclosures in SEC filings in the period 1997–2001. In 2002, 11 Wells notices were disclosed, followed by 14 in 2003, 31 in each of 2004 and 2005, 18 in 2006, and 20 in 2007. We analyzed in detail the 58 investigations of companies that disclosed the receipt of a Wells notice between April 2002 and January 2007 and were traded continuously on a major stock exchange from the initial public disclosure of an SEC investigation

through the public disclosure of the receipt of a Wells notice.<sup>4</sup> For each of these investigations, we also reviewed public press releases to determine the date and time of each disclosure.

For each of the 58 investigations we researched, we determined whether the company had disclosed an informal SEC investigation, a formal SEC investigation, or both, prior to receipt of the Wells notice, and we found that 33 of the 58 investigations were first disclosed at the informal stage, and 10 were first disclosed at the formal stage. For the remaining 15 investigations, the disclosure of the Wells notice was the first disclosure to the market of an SEC investigation.

Examination of the type and timing of the disclosures of the 58 investigations provides a rudimentary metric for evaluating the length of the investigations of target companies, which is shown in figure 2. For the 33 investigations that were disclosed at the informal investigation stage, the average length of time between the announcement of the informal investigation and the announcement of the Wells notice was one year and four months. For the 29 announcements that disclosed a formal investigation prior to receipt of a Wells notice (10 of which had not been preceded by an announcement of an informal investigation and 19 of which were announcements of a formal investigation following an announcement of an informal investigation), the average length of time between the announcement of the formal investigation and the announcement of the Wells notice was slightly longer than a year. For the 19 investigations for which both an informal investigation disclosure and a formal investigation disclosure were made prior to the receipt of a Wells notice, the average length of time between the announcement of the informal investigation and the announcement of the formal investigation was approximately five months.<sup>5</sup>

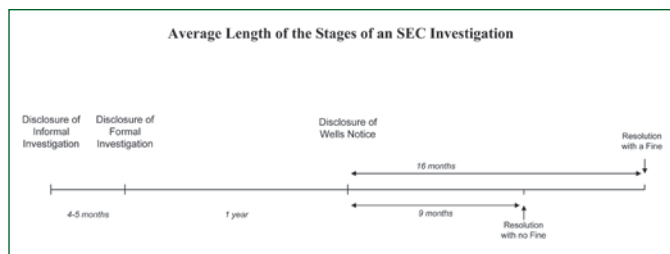


FIGURE 2

### Stock Price Reactions to Disclosures of Investigations

With the data set of 58 investigations identified—some of which were disclosed prior to receipt of a Wells notice—we turned to the question of the stock price reaction to each investigation-related disclosure. To analyze the stock price movement associated with target companies’

disclosures, we performed a separate event study analysis for each investigation in our data set. Event study methodology is used to determine whether a company’s actual stock price movement on a given day is significantly different from the price movement that one would expect for that day, based on the stock’s historical price movements relative to the market. The typical relationship between movements in the company’s stock price (the “returns”) and the overall market is estimated through regression analysis (a “market model”), which enables a prediction of how a company’s stock is expected to have performed on a given day. The difference between the actual and predicted returns—the “market-adjusted return”—indicates the portion of a stock’s return that is not attributable to market movement.

	Number of Disclosures	Mean Market-Adjusted Return on Wells Notice Disclosure	Median Market-Adjusted Return on Wells Notice Disclosure
Total Number of Wells Investigations Disclosed	58	-2.59%	-1.74%
Informal Investigation disclosed at Initial Disclosure	33	-2.69%	-1.69%
Formal Investigation disclosed at Initial Disclosure	10	-2.84%	-2.44%
Wells Notice receipt disclosed at Initial Disclosure	15	-2.21%	-0.86%

FIGURE 3

The market-adjusted return on any given day can be the result of normal (random) movements. However, a market-adjusted return in excess of a certain threshold may be suggestive of a material change in the mix of information regarding the company.

Figure 3 shows that the average market-adjusted return on the day of the Wells notice disclosure for the target company of all 58 investigations was negative 2.59 percent. This average, across all 58 observations, is statistically significant. The median market-adjusted return was negative 1.74 percent and statistically significant. Thus, on average, disclosure of a Wells notice leads to a decline in stock prices.

Evidence shows, nonetheless, that market participants discern firm-specific differences across announcements of receipt of Wells notices. Specifically, of the 58 investigations, only 17 (29 percent) resulted in negative and statistically significant declines in the target company’s stock price upon disclosure of the Wells notice. Thus, for any individual case, disclosure of a Wells notice may or may not be perceived as significant negative news by market participants.

Disclosures of an informal investigation or a formal investigation prior to the receipt of the Wells notice also resulted on average in negative, statistically significant stock price movements. However, there was no significant difference between the average market-adjusted returns on the day of the disclosure of receipt of a Wells notice

for investigations that had been previously disclosed and the market-adjusted returns related to those that had not. These findings are consistent with the hypothesis that market participants perceive the disclosure of an informal or formal investigation as a signal of a higher likelihood that the outcome of the investigation will have a material impact on the company relative to announcing only the receipt of the Wells notice. Otherwise, one would expect the disclosure of the Wells notice that was the first disclosure of the investigation to result in a larger negative price movement than disclosures that followed prior announcements of the investigation.

### Resolutions of Investigations

At the time we concluded our study, we had identified announcements of the resolution of the SEC’s investigation for 43 of the 58 investigations in our data set. Of those 43 investigations, the average time between the announcement of receipt of a Wells notice and the announcement of a resolution was about 13 months.

To distinguish among outcomes of actions taken by the SEC, we analyzed the incidence of fines levied against the targets of the investigations. For the 17 investigations resulting in no fine being imposed on the target company or individual, the average time between the Wells notice disclosure and the resolution disclosure was approximately nine and a half months. For the 26 investigations resulting in a fine, the time between Wells notice disclosure and resolution announcement was almost 16 months.

Investigation Disclosures	Total Number of Investigations	By Resolution Outcome	
		Investigations Not Resulting in a Fine	Investigations Resulting in a Fine
Wells Notice Only	12	8	4
Informal or Formal Investigation Prior to Wells Notice	16	6	10
Informal and Formal Investigations and Wells Notice	15	3	12
<b>Total</b>	<b>43</b>	<b>17</b>	<b>26</b>

FIGURE 4

Figure 4 shows the breakdown of resolution outcomes by investigation-related disclosures. Compared with other Wells notice recipients, companies that had announced the investigation prior to the Wells notice were more likely to have a fine imposed as a result of the investigation. Conversely, companies that first announced the investigation with the disclosure of a Wells notice were

more likely not to be fined. Although these findings are based on a small number of observations, they are consistent with the notion that companies are more likely to disclose informal and formal investigations when it is more likely the outcome will be negative.

### Conclusion

With the current market turmoil and push for greater regulation in the securities markets, many observers expect a ramp-up in the number of investigations initiated by the SEC. If recent trends continue, the companies that do not believe that an investigation will result in a material impact on the company, and therefore do not disclose the early stages of an investigation, will not necessarily incur a larger stock price decline upon disclosure of the Wells notice than if they had previously disclosed the investigation. ✱

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1. SEC, DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL 20 (Oct. 6, 2008).
2. If prompt enforcement action is necessary to protect investors, the commission may choose not to issue a Wells notice before taking action such as requesting a temporary restraining order.
3. The term “Wells notice” has its origins in the recommendations made by an advisory committee chaired by John Wells.
4. Investigations were removed from our original data set if the target companies did not trade continuously on a major stock exchange (NYSE, Nasdaq, or American Stock Exchange) from the initial public disclosure of the SEC investigation through the public disclosure of a Wells notice, or if they fell outside our period of examination.
5. It is important to note that these figures are based on dates of public disclosures identified by Cornerstone Research and therefore do not necessarily reflect the actual dates when target companies were notified of an initiation of or a change in an SEC investigation.