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The Irredeemable Relevance Of SEC Enforcement Action

Law360, New York (February 21, 2012, 1:37 PM ET) -- In November 2011, the U.S. Securities and Exchange Commission (SEC) issued a cease-and-desist order against Fifth Third Bancorp in connection with its redemption of a class of its trust preferred securities.[1]

While these securities and the circumstances of their redemption are unusual, this order is relevant to any company that plans to redeem any of its publicly held securities, such as utility or other energy companies that commonly have redeemable debt securities or preferred stock outstanding.

Background

According to the order, the facts were simple. The securities in question were redeemable at the option of Fifth Third if a “capital treatment event” occurred. In April 2011, Fifth Third determined that a “capital treatment event” had occurred as a result of the Dodd-Frank Act and sought approval of the redemption from the Federal Reserve of Cleveland pursuant to federal banking regulations.

The redemption was approved on Friday, May 13, 2011. On Monday, May 16, Fifth Third gave redemption instructions to the trustee, who sent a redemption notice to the Depository Trust Company (DTC) with a redemption price of $25.18. DTC posted the redemption notice on its Legal Notification System (LENS) at 2:47 a.m. on May 17.

Despite DTC’s posting early on May 17, many of the investors in the trust-preferred securities did not learn of the redemption until after the close of trading on May 17 or before the opening of trading on May 18. On May 16 and 17, the securities traded between $26.49 and $26.68 per security.

On May 18, the securities opened at $26.66, and the volume in trading increased substantially — more than two million securities were traded in less than two hours. By 10 a.m. on May 18, Fifth Third noticed the unusually heavy trading and filed a Form 8-K shortly thereafter disclosing the redemption, which was posted to the SEC’s EDGAR system at 11:28 a.m. The securities closed that day at $25.20 per security.

The SEC charged that Fifth Third violated Section 13(a) of the Securities Exchange Act of 1934 and Regulation FD — passed by the SEC to prevent selective disclosure by public companies to market professionals and securityholders — as a result of its conduct.

The SEC claimed that Fifth Third "selectively disclosed" the redemption through DTC, and not to the public generally, by only providing notice through the trustee to DTC. The SEC claimed that Fifth Third did not issue a Form 8-K or other public notice of the redemption until after it became aware of the impact that the selective disclosure had on the market.

Fifth Third voluntarily compensated investors who were harmed by the timing of its disclosure and adopted and implemented various additional policies and procedures, settled the SEC's enforcement action without admitting or denying the allegations, and consented to the entry of the cease-and-desist order.

Implications

Why is this order particularly relevant to utility and other energy companies and their securities? The SEC's position was that Fifth Third did not consider the requirements of Regulation FD in connection with the redemption of its securities, nor did it consider the effect that the selective disclosure of the redemption, without a simultaneous disclosure to the rest of the investing public, would have on the market for the securities.

This suggests that a company planning to redeem any of its securities should consider whether the redemption is material information that needs to be disclosed under Regulation FD, consistent with the position taken by the SEC in the Regulation FD adopting release[2], which includes "events regarding the issuer's securities" such as "calls of securities for redemption" in a list of types of information or events that should be reviewed carefully to determine whether they are material.

Utility and other energy companies often have significant amounts of redeemable debt securities or preferred stock outstanding and, therefore, this order is particularly relevant to those companies.

Each redemption is different, and calls for the consideration of a number of issues, but one question should always be asked: Is the redemption price significantly different from the market price for those securities? If the redemption price differs significantly from the market price, whether higher or lower, there is a risk that investors with knowledge of the redemption could trade securities to take advantage of that knowledge.

If notice of the redemption is only given through DTC, then DTC members, LENS subscribers and, ultimately, beneficial owners of the securities would have access to that information before the public generally.

For securities that are frequently traded on an exchange or other public market, there is typically good evidence of the market price. If the market price is the same as the redemption price and has been fairly stable, there may be no need for public disclosure of the redemption.

However, if the market price is significantly different from the redemption price or shows some volatility, then there is an increased likelihood that the redemption could be considered material information warranting public disclosure of the redemption in a Regulation FD-compliant manner.

If a security is not frequently traded on an exchange or public market, neither the company nor its investors may have good information regarding the market price of the security, so it is important for the company to evaluate whether public disclosure of the redemption is required by Regulation FD or is otherwise advisable.

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[1] The cease-and-desist order is available online at www.sec.gov/litigation/admin/2011/34-65808.pdf.

[2] Available online at www.sec.gov/rules/final/33-7881.htm.

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