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SECOND CIRCUIT REVIEW

Expert Analysis

Ruling Broadening Duty of Disclosure in Securities Filing Creates Circuit Split

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This month, we discuss *Stratte-McClure v. Morgan Stanley*,[1] in which the U.S. Court of Appeals for the Second Circuit affirmed an order granting defendants' motion to dismiss. In its decision, written by Judge Debra Ann Livingston and joined by Judge Jose A. Cabranes and Judge Richard C. Wesley, the court concluded as a matter of first impression for this circuit that Item 303 of Regulation S-K imposes a duty of disclosure on a company filing a Form 10-Q which, under certain circumstances, may give rise to liability under Section 10(b) and Rule 10b-5. This decision creates a split with the U.S. Court of Appeals for the Ninth Circuit.

Background

Lead plaintiffs State-Boston Retirement System and Fjarde AP-Fonden brought a putative securities fraud class action under Sections 10(b) and 20(a), 15 U.S.C. §§78j(b) & 78t(a), of the Securities Exchange Act of 1934 for losses that they said they sustained when Morgan Stanley and six of its officers and former officers allegedly made material misstatements and omissions during the class period. Plaintiffs alleged that defendants made these misstatements and omissions to try to conceal Morgan Stanley's exposure to and losses from the subprime mortgage market.

Plaintiffs claimed that Morgan Stanley did not properly disclose in its 10-Q filings that the company (1) held a long position in a massive proprietary trade involving the purchase and sale of credit default swaps on collateralized debt obligations backed by mezzanine tranches of subprime residential mortgage-backed securities; (2) had sustained losses on that position in the second and third quarters of 2007; and (3) was likely to incur additional significant losses on the position in the future.

Item 303 of Regulation S-K requires companies to disclose on their 10-Q filings (and other SEC-mandated filings) any "known trends, or uncertainties that have had or that the registrant reasonably expects will have a material…unfavorable impact" on net sales or revenues or income from continuing operations."[2]

Because of Morgan Stanley's supposed omissions, plaintiffs alleged that Morgan Stanley violated Item 303 and that this violation provided an actionable basis for their claims.

Prior Proceedings

Plaintiffs initially filed their complaint in the U.S. District Court for the Central District of California. After an amended complaint was filed, the case was transferred to the Southern District of New York, where defendants moved to dismiss all claims under Federal Rules of Civil Procedure 9(b) and 12(b)(6) and Section 78u-4(b) of the Private Securities Litigation Reform Act.

The district court granted the motion to dismiss, ruling on one claim that plaintiffs had failed to specify why defendants' statements about risk and its trading positions were false or misleading, and on another claim that plaintiffs had failed to plead loss causation. The district court granted plaintiffs leave to amend their pleadings with regard to these two claims, but dismissed the rest of plaintiffs' claims with prejudice.

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On June 9, 2011, plaintiffs filed a second amended complaint and defendants again moved to dismiss. The district court again found that plaintiffs failed to sufficiently plead loss causation and falsity. In its analysis, however, the district court this time found that Morgan Stanley had a duty under Item 303 to disclose the long position in its 2007 Form 10-Q filings, and that such a duty could form the basis of liability for claims such as plaintiffs' had they in fact been properly pleaded.

Second Circuit's Decision

The Second Circuit affirmed the decision of the lower court, finding that the district court properly dismissed plaintiffs' Section 10(b) claim based on defendants' supposed omissions violating Regulation S-K's Item 303. The court nevertheless concluded as a matter of first impression for the circuit that a failure to make a required Item 303 disclosure in a 10-Q filing is "indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim."[3] In so holding, the court ruled that such an omission will only be actionable if it satisfies the materiality requirements outlined in *Basic v. Levinson*[4] and if all the other requirements to sustain an action under Section 10(b) (including scienter) are fulfilled.

Standard for Actionable Item 303 Violation Under Section 10(b). In beginning its analysis, the court recognized that Item 303 of Regulation S-K imposes disclosure requirements on companies filing SEC-mandated reports. The court specifically emphasized that the SEC has provided guidance on Item 303 and has clarified that disclosure is needed where management knows of a trend, demand, commitment, event, or uncertainty that is reasonably likely to have material effects on the company's financial condition.

The court noted that it previously has held that failing to comply with Item 303 with respect to a registration statement or prospectus is actionable under Sections 11 and 12(a)(2) of the Securities Act of 1933. In doing so, it cited its previous decisions in *Panther Partners v. Ikanos Communications*[5] and *Litwin v. Blackstone Group*.[6] The court additionally noted that it—along with its sister circuits—has "long recognized that a duty to disclose under Section 10(b) can derive from statutes or regulations that obligate a party to speak."[7]

> The court concluded that Item 303 of Regulation S-K imposes a duty of disclosure on a company filing a Form 10-Q which may give rise to liability under Section 10(b) and Rule 10b-5.

The court then examined both the purpose of Item 303 and the way a reasonable investor would interpret the absence of such a disclosure. It found that Item 303 was intended to be "an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations," and thus that the absence of a disclosure would imply the nonexistence of "known trends or uncertainties" expected to have a "material…unfavorable impact on…revenues or income from continuing operations."[8] In doing so, the court therefore concluded that Item 303 imposes the type of duty to speak that may give rise to liability under Section 10(b).

The court held, however, that the failure to make a required disclosure under Item 303 by itself will be insufficient to state a claim for securities fraud under Section 10(b). First, it noted that, under *Basic*, only material omissions are actionable, and that Item 303's disclosure standards do not mirror the materiality standard set out in *Basic*. Thus, it concluded that in order to sustain a claim under Section 10(b) and Rule 10b-5 for a violation of Item 303's disclosure requirements, a plaintiff must allege not only that the defendant failed to comply with Item 303 in a Form 10-Q or other filing, but also that the omitted information was material under *Basic's* probability/magnitude test. Second, the court stated that a plaintiff must also sufficiently plead the other elements of his claim, including scienter. A failure by a plaintiff to sufficiently plead any of these elements will be fatal.

The court noted that its holding created a circuit split, given the Ninth Circuit's recent opinion in *In re NVIDIA Corp. Securities Litigation*,[9] which specifically held that Item 303's disclosure duty is not actionable under Section 10(b) and Rule 10b-5. The Second Circuit found, however, that *Oran v. Stafford*[10]—the case on which the Ninth Circuit relied in *In re NVIDIA*—simply had determined that a violation of Item 303 does not automatically give rise to a material omission under Rule 10b-5.

The court criticized the Ninth Circuit's application of *Oran*, noting that *Oran* had suggested, without deciding, that certain instances of a violation of Item 303 actually could give rise to a material 10b-5 omission. Thus, the Second Circuit found *Oran* to be "consistent" with its decision that "failure to comply with Item 303 in a Form 10-Q can give rise to liability under Rule 10b-5 so long as the omission is material under *Basic*, and other elements of Rule 10b-5 have been established."[11]

Additionally, the court criticized the Ninth Circuit as having misun-

derstood the interplay between Rule 10b-5 and Section 12(a)(2) of the Securities Act. It noted that the Ninth Circuit's finding that *Litwin* and *Panther Partners* were irrelevant to its interpretation of Rule 10b-5 made little sense, given that those decisions "provide firm footing" for the Second Circuit's conclusion.[12]

The court concluded that in order to sustain a claim under Section 10(b) and Rule 10b-5 for a violation of Item 303's disclosure requirements, a plaintiff must allege not only that the defendant failed to comply with Item 303 in a Form 10-Q or other filing, but also that the omitted information was material under 'Basic's' probability/magnitude test.

Application to Plaintiffs' Claims. The Second Circuit then went on to analyze plaintiffs' claims. It found that plaintiffs adequately had alleged that defendants breached their Item 303 duty to disclose. It noted that Morgan Stanley had failed to disclose that it faced a deteriorating subprime mortgage market that was likely to cause trading losses and materially affect Morgan Stanley's financial condition. In doing so, it rejected defendants' argument that they had satisfied their Item 303 obligations by disclosing the deterioration of the real estate, credit, and subprime mortgage markets, and its potential to negatively affect Morgan Stanley, finding that Morgan Stanley's disclosures had been "generic, spread out over several different filings, and often unconnected to the company's financial position."[13] The court concluded that such "generic cautionary language" could not satisfy Item 303.[14]

The court, however, did cabin the disclosure obligations of Morgan Stanley (and assumedly other companies in the same position). It noted that the obligations under Item 303 were not as extensive as the district court had found. In doing so, it emphasized that the SEC has never required a company to disclose its internal business strategies or to identify specifics of its trading positions. Rather, it found that, to have complied with Item 303, Morgan Stanley would only have needed to disclose that it faced deteriorating real estate, credit, and subprime mortgage markets where it had significant exposure and that it may face subsequent material trading losses.

In continuing its analysis, the court assumed that such an omission by Morgan Stanley would be material, but affirmed dismissal of the plaintiffs' claim since plaintiff had failed to adequately plead scienter. It noted that the heightened pleading standards of the Private Securities Litigation Reform Act required plaintiffs to plead Section 10(b) claims by alleging facts that give rise to a "strong inference that the defendant acted with the required state of mind."[15] It held that plaintiffs' allegations did not meet this critical standard.

The court also affirmed the district court's order dismissing plaintiffs' other claims, noting that the alleged misstatements were not misleading and that plaintiffs did not adequately plead scienter for those claims as well.

Conclusion

In this decision of first impression for the circuit, the court creates a split with the Ninth Circuit regarding whether Item 303 creates an actionable disclosure duty that could form the basis of securities fraud claims brought under Section 10(b) and Rule 10b-5. It has made clear that, at least in the Second Circuit, companies must be prepared to face potential liability under Section 10(b) stemming from a failure to adequately disclose information in SEC filings as required by Item 303 of Regulation S-K. Though the burden on plaintiffs to adequately plead each element of the underlying claim remains high, companies should be conscious of the newly defined obligation to disclose and the risks of not making robust disclosures, at least until the Supreme Court weighs in on the issue.

1. *Stratte-McClure v. Morgan Stanley*, No. 13-0627-cv, 2015 WL 136312 (2d. Cir. Jan. 12, 2015).
2. 17 C.F.R. §229.303(a)(3)(ii).
3. *Stratte-McClure*, 2015 WL 136312 at *5.
4. *Basic v. Levinson*, 485 U.S. 224 (1988).
5. *Panther Partners v. Ikanos Comm'ns*, 681 F.3d 114 (2d Cir. 2012).
6. *Litwin v. Blackstone Group,* 634 F.3d 706 (2d Cir. 2011).
7. *Stratte-McClure*, 2015 WL 136312 at *6.
8. Id. (citing Exchange Act Release No. 6835 and 17 C.F.R. §229.303(a)(3)(ii)).
9. *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014).
10. *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).
11. *Stratte-McClure*, 2015 WL 136312 at *7.
12. Id.
13. Id. at *9.
14. Id. (quoting *Panther Partners*, 681 F.3d at 122).
15. Id. at *10 (citing the Private Securities Litigation Reform Act, 15 U.S.C. §78u4(b)(2)(A)).