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Second Circuit Finds That Failure to Make Required Item 303 Disclosure Can Provide Basis for Securities Fraud Claim

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Introduction

Recently, the United States Court of Appeals for the Second Circuit in *Stratte-McClure v. Morgan Stanley*, No. 13-0627-CV, 2015 WL 136312 (2d Cir. Jan. 12, 2015) affirmed dismissal of a securities fraud class action lawsuit. The Court also ruled, as a matter of first impression in the Second Circuit, that "a failure to make a required disclosure under Item 303 of Regulation S-K … in a 10-Q filing is an omission that can serve as the basis for a Section 10(b) securities fraud claim, if the omission satisfies the materiality requirements outlined in *Basic v. Levinson*, 485 U.S. at 224, and if all of the other requirements to sustain an action under Section 10(b) are fulfilled."[1]

The Court's decision clarifies that Item 303's affirmative duty to disclose in Form 10-Qs can form the basis for a Section 10(b) claim under the Securities and Exchange Act of 1934, and highlights the Second Circuit's disagreement with the Ninth Circuit, which recently held in *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014) "that Item 303's disclosure duty is not actionable under Section 10(b) and Rule 10b-5."[2]

Case Background

Lead plaintiffs were investors who brought a securities fraud class action against defendants Morgan Stanley and six of its officers and former officers. Plaintiffs alleged that defendants "made material misstatements and omissions … in an effort to conceal Morgan Stanley's exposure to and losses from the subprime mortgage market."[3] In particular, plaintiffs alleged that a trade executed by Morgan Stanley's Proprietary Trading Group in December 2006, consisting of a $2 billion short position and $13.5 billion long position in subprime mortgages, caused substantial losses to Morgan Stanley, and that defendants materially misrepresented Morgan Stanley's exposure to the subprime market (the "exposure claim") and overstated the company's earnings in the third quarter of 2007 by not sufficiently marking down the value of its long position and disclosing it in its quarterly statement (the "valuation claim").[4]

Procedural History

After their amended complaint was dismissed with leave to replead certain claims, plaintiffs filed a second amended complaint, which defendants moved to dismiss under Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure and Section 78u-4(b) of the Private Securities Litigation Reform Act. Relying on two intervening Second Circuit decisions that held that Item 303 may provide a basis for disclosure obligations under Sections 11 and 12(a)(2) of the Securities Act of 1933 (the "Securities Act"),[5] the district court held that Morgan Stanley had a duty under Item 303 to disclose its long position in its 2007 Form 10-Q filings. Nevertheless, the district court dismissed plaintiffs' 10b-5 claim, holding that plaintiffs failed to plead loss causation for the valuation claim and failed to plead "a strong inference of scienter" for the exposure claim.[6] Plaintiffs appealed.

Ruling

The Second Circuit ruled that a failure to disclose material information under Item 303 can serve as the basis for a Section 10(b) securities fraud claim when the omission is material under the Supreme Court's *Basic v. Levinson*[7] standard. In reaching this conclusion, the Second Circuit observed that the disclosure obligations under Item 303, which requires disclosure of a "known trend … likely to come to fruition … unless management determines that a material effect on the registrant's financial conditions or results of operations is not reasonably likely to occur,"[8] is broader than the *Basic* materiality standard applied for Rule 10b-5 claims, which requires "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[9] As such, the Second Circuit set forth the following framework to sustain a Section 10(b) claim based upon an alleged Item 303 non-disclosure:

> [A] plaintiff must first allege that the defendant failed to comply with Item 303 in a 10-Q or other filing. Such a showing establishes that the defendant had a duty to disclose. A plaintiff must then allege that the omitted information was material under *Basic's* probability/magnitude test, because 10b-5 only makes unlawful an omission of material information that is necessary to make statements made … not misleading.[10]

In addition, the Second Circuit noted that a plaintiff must also sufficiently plead the other elements of a Rule 10b-5 claim, namely, scienter, reliance, and causation of economic loss.[11]

In applying the above framework, the Second Circuit stated that plaintiffs had "adequately alleged that Defendants breached their Item 303 duty to disclose that Morgan Stanley faced a deteriorating subprime mortgage market that, in light of the company's exposure to the market, was likely to cause trading losses that would materially affect the company's financial condition."[12] The Second Circuit also assumed that this omission was material under *Basic*. Importantly, however, the Second Circuit disagreed with the district court that this required Morgan Stanley to disclose the details of its long position, since this would "give competitors notice of proprietary strategies and information."[13] Instead, the Second Circuit determined that "Morgan Stanley needed to disclose only that it faced deteriorating real estate, credit, and subprime mortgage markets, that it had significant exposure to those markets, and if trends came to fruition, the company faced trading losses that could materially affect its financial condition."[14] Regardless, the Second Circuit affirmed the district court's dismissal of the Section 10(b) claim because plaintiffs failed to adequately plead scienter.

At Odds With the Ninth Circuit

The Second Circuit noted that its holding that Item 303 may trigger Section 10(b) liability "is at odds" with the Ninth Circuit opinion in *In re NVIDIA Corp. Securities Litigation*. Relying heavily on the Third Circuit decision of *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), the Ninth Circuit ruled that Item 303 imposes no duty of disclosure and is not actionable under Section 10(b) and Rule 10b-5. The Second Circuit also relied on *Oran*, reasoning that the Third Circuit merely stated that an Item 303 omission "does not *automatically* give rise to a *material* omission under Rule 10b-5."[15] In the Second Circuit's view, the *Oran* court "actually suggested, without deciding, that in certain instances a violation of Item 303 *could* give rise to a material 10b-5 omission," thereby disagreeing with the Ninth Circuit's reading of *Oran*.[16] Further, the Second Circuit disagreed with the Ninth Circuit's opinion in *NVIDIA* that decisions holding that Item 303 creates a duty of disclosure under Section 12(a)(2) of the Securities Act were irrelevant to Rule 10b-5 cases since the text of the provisions prohibiting omissions are identical.[17]

Practical Implications

There are several key practical implications flowing from the *Morgan Stanley* decision. Importantly, although the Second Circuit has now stated that omissions of information required by Item 303 can sustain a Rule 10b-5 securities fraud claim, the materiality threshold established in *Basic* must still be satisfied. In addition, by rejecting the district court's determination that Item 303 necessitated Morgan Stanley revealing its trading positions, the Second Circuit ensured that a company's disclosure obligations do not require revealing internal business strategies or other proprietary information. Nevertheless, the decision puts companies on notice that Item 303 "require[s] disclosure of a known trend and the manner in which it might reasonably be expected to materially impact a company's overall financial position"[18] and that generic cautionary language about market trends does not satisfy Item 303 and can potentially trigger the filing of a Section 10(b) claim. Finally, with a disagreement among circuits now in play, the Supreme Court may ultimately be called upon to settle the issue of whether Item 303 can support a claim under Rule 10b-5.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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[1] *Stratte-McClure*, 2015 WL 136312, at *11.

[2] *Id.* at *7.

[3] *Id.* at *1.

[4] *Id.* at *2.

[5] *See Panther Partners Inc. v. Ikanos Communications, Inc.*, 681 F.3d 114 (2d Cir. 2012); *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. 2011).

[6] *Stratte-McClure*, 2015 WL 136312, at *4.

[7] 485 U.S. 224 (1988).

[8] *Stratte-McClure*, 2015 WL 136312, at *7 (quoting SEC Exchange Act Release No. 33-6835, 54 Fed. Reg. 22427, 22430 (May 24, 1989)).

[9] *Basic*, 485 U.S. at 238 (quoting *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).

[10] *Stratte-McClure*, 2015 WL 136312, at *7 (internal quotations omitted).

[11] *See id.*

[12] *Id.* at *8.

[13] *Id.* at *9.

[14] *Id.*

[15] *Id.* at *7 (quoting *Oran*, 226 F.3d at 228).

[16] *Id.*

[17] *See id.* at *8.

[18] *Id.* at *9 (quoting *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 718-19 (2d Cir. 2011)) (internal quotations omitted).