



SECOND CIRCUIT REVIEW

Expert Analysis

Application of Bespeaks-Caution And Loss Causation Defenses

This month we discuss *Iowa Public Employees' Retirement System v. MF Global, Ltd.*,¹ in which the U.S. Court of Appeals for the Second Circuit addressed the bespeaks-caution doctrine and loss causation defense in the context of securities claims brought under §§11 and 12 of the Securities Act of 1933. The decision, written by Chief Judge Dennis Jacobs, and joined by Judges Barrington D. Parker and Peter W. Hall, examined two sets of alleged misstatements and omissions contained in defendant hedge fund's Prospectus and Registration Statement.

Vacating a portion of the lower court's opinion, the Second Circuit clarified the bespeaks-caution doctrine and its application to statements that "contain some elements that look forward and others that do not."² In addition, the appellate court relied upon the affirmative defense of loss causation to affirm the dismissal of one of plaintiffs' claims because it was "apparent on the face of the complaint" that the alleged omission did not cause plaintiffs' damages.³

Procedural History

In 2007, the hedge fund Man Group announced that it would spin off its brokerage arm, MF Global, via an IPO on the New York Stock Exchange. MF Global filed a Registration Statement on May 31, 2007, and a Prospectus on July 20, 2007. Both the Registration Statement and Prospectus "described in general terms MF Global's risk management policies and procedures," including descriptions of "MF Global's program for monitoring its employees and brokers, its risk management structure, its approach to risk, and its ability to minimize conflicts of interest and promote financial stability by generally refraining from proprietary trading." The documents also "addressed various factors that might undermine MF Global's risk management efforts, including employee misconduct, human or technological failures, and lack of information."⁴

Several months later, on Feb. 27, 2008, a



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registered MF Global broker entered into contracts for wheat futures that exceeded his authorized trading limit per MF Global's regulations. The contracts resulted in a \$141.5 million loss, which MF Global was ultimately responsible for settling. The following day, on an investor conference call, MF Global CEO Kevin R. Davis acknowledged that the firm's "existing internal controls" could have stopped the trades, but that these controls were

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not applied to brokers when they traded on their own accounts or took orders by phone. Instead, "in order to speed trades," the firm "allowed some internal terminals to not have the buying power control," a policy Mr. Davis admitted was a "mistake."⁵ On the same day as the call, MF Global's stock price fell 28 percent. It fell another 17 percent on Feb. 29. Overall, MF Global suffered a market capitalization loss that exceeded \$1.1 billion.⁶

In March 2008, the district court received the first complaint alleging that MF Global misrepresented, or failed to disclose, relevant material information in its Registration Statement and Prospectus. Eventually, the court consolidated five actions for coordinated pretrial proceedings, following which plaintiffs filed a Consolidated Class Action Complaint (CCAC) alleging violations of §§11, 12(a)(2), and 15 of the Securities Act. According to the CCAC, plaintiffs purchased MF Global shares "pursuant and/or traceable to the

false and misleading registration Statement and Prospectus and [were] damaged thereby."

The CCAC targeted MF Global; individual defendants who, as officers of MF Global, signed the Registration Statement; and underwriters for the MF Global IPO. In response, defendants denied that the Registration Statement or Prospectus contained materially false or misleading information and further claimed that the alleged misrepresentations and omissions did not cause plaintiffs' losses.⁷

In its analysis, the district court (Marrero, J.) broke the alleged misrepresentations and omissions into groups and analyzed them separately. Two groupings were relevant on appeal: first, misrepresentations and omissions relating generally to the strengths and weaknesses of MF Global's risk management system and, second, omissions relating to the specific features of MF Global's client accounts.⁸

As to the former, the CCAC alleged that the Registration Statement and Prospectus misrepresented and omitted information about MF Global's risk management protocols, in part because the documents failed to disclose that "trades carried out by traders on behalf of MF Global were not monitored in the same way as clients' trading activities" and that the firm's risk controls "could be turned off, ignored, or overridden."

The district court summarized these claims as "basically amount[ing] to an allegation that MF Global's risk management system was not as robust as described in the language quoted from the Prospectus."⁹ The district court then analyzed these risk-related statements under the bespeaks-caution doctrine, which provides in general that certain alleged misrepresentations are "immaterial as a matter of law because it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language."¹⁰

Though the statements in question were not "forward-looking," the court noted that the case law was "ambiguous" as to whether the bespeaks-caution doctrine only applied to prospective statements. Further, according to the court, plaintiffs' objections to "misrepresentations about specific or general shortcomings in MF Global's risk management system that existed at the time the Prospectus was issued" were actually "objections to Defendant's alleged

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failure to disclose the possibility that the risk management system might be unable to prevent future negative outcomes.” Applying the bespeaks-caution doctrine to these omissions, the district court concluded that “the Prospectus contained sufficient warnings regarding the potential for the risk management system to fail” and dismissed plaintiffs’ claims.¹¹

The district court also dismissed plaintiffs’ claims that MF Global documents omitted material information regarding client account procedures. According to plaintiffs’ allegations, the Prospectus and Registration Statement failed to disclose “that traders did not have limits when trading for clients, and that with proper passwords anyone could access client accounts and trade in them at any time.” The district court found that the CCAC established that the Feb. 27 trading incident and the subsequent drop in MF Global’s stock price was unrelated to trading limits or client account access. Noting that “a lack of loss causation that is apparent on the face of the complaint may constitute a successful [12(b)(6)] defense,” the court granted defendants’ motion to dismiss as to this set of alleged omissions.¹²

The Second Circuit Decision

On appeal, the Second Circuit vacated the district court’s ruling on the bespeaks-caution doctrine and affirmed a portion of the district court’s loss causation holding.

Analyzing the district court’s application of the bespeaks-caution doctrine, the Second Circuit emphasized that the doctrine only applies to forward-looking statements. According to the Second Circuit, the bespeaks-caution doctrine, like other safe harbor provisions, aims to encourage issuers to disclose information. Under the law, predictive statements are non-actionable as long as they are accompanied by the appropriate cautionary language. Taken as a whole, these disclosures “express[] the issuer’s inherently contingent prediction of risk or future cash flow.”¹³

In contrast, the court explained that a non-forward-looking statement “provides an ascertainable or verifiable basis for the investor to make his own prediction.”¹⁴ For example, the Prospectus’ alleged failure to disclose the fact that MF Global’s risk management controls “did not apply to the Company’s employees...[when] trading for their own accounts,” was ascertainable at the time of omission. Similarly, while MF Global’s description of its risk-management system as “robust” suggested actions that the fund might take to reduce risks, the court held that the bespeaks-caution doctrine should not apply to the extent that the statement communicated “present or historical fact as to the measures taken.”¹⁵

Based on this analysis, the Second Circuit concluded that the district court applied the bespeaks-caution doctrine “too broadly,” because even when a statement combines present fact with future prediction, “the forward-looking elements and the non-forward-looking are severable.” Advising that courts are competent to distinguish between these statements of forecast and statements of fact, the Second Circuit remanded the risk management claims to allow the district court to apply the clarified doctrine.¹⁶

The Second Circuit also applied a loss causation

analysis to plaintiffs’ “client account” allegations. The court explained that a “causation defense prevails if the defendant ‘proves’ that an otherwise recoverable loss was not caused by the alleged misstatement or omission.”¹⁷ While acknowledging that under the Securities Act, “[l]oss causation is not an element of a plaintiff’s prima facie case” and, instead, “the absence of loss causation is an affirmative defense,” the court also noted that “[a]n affirmative defense may be raised by a pre-answer motion to dismiss under Rule 12(b)(6)...if the defense appears on the face of the complaint.”¹⁸

The Second Circuit agreed with the district court’s conclusion that the Feb. 27 trading incident had nothing to do with client accounts or access protocols. The incident, however, led to the revelation of risk management deficiencies, as MF Global admitted that it deactivated internal controls for “brokers at the firm who traded for themselves or took customer orders by phone.”¹⁹ The Second Circuit held that this disclosure could have impacted MF Global’s stock price because it revealed new information about the level of risk MF Global assumed and was relevant to the future of MF Global’s client account business. Therefore, the court vacated the dismissal of plaintiffs’ claims that the Prospectus failed to disclose that telephone orders were not subject to the firm’s risk management policies.

The Second Circuit affirmed the district court’s dismissal of plaintiffs’ claims regarding the Prospectus’ failure to disclose the extent of access to client accounts. Neither the Feb. 27 trading incident, nor subsequent related events, led to any revelations regarding password access. Without saying as much, the panel decided that if this information was not disclosed in the aftermath of the trading incident, it could not have impacted the stock price at that time. The court, therefore, held that it was “apparent on the face of the complaint that the stock price decline (and the plaintiffs’ resulting losses) cannot be attributed to the prospectus’s failure to disclose that alleged fact.”²⁰

Conclusion

The Second Circuit decision in *Iowa Public Employee’s Retirement Fund* clarifies that the bespeaks-caution doctrine applies only to forward-looking statements and calls upon district courts to distinguish between predictive claims and present facts. In addition, the decision provides strong support for the application of loss causation to Securities Act claims, holding that a court can dismiss such claims when a defendant shows that it is “apparent on the face of the complaint” that the alleged misstatements or omissions did not cause the alleged damages.²¹



1. Docket No. 09-3919-cv, 2010 WL 3547602 (2d Cir. Sept. 14, 2010).

2. Id. at 4.

3. Id. at 6 (internal quotation marks and brackets omitted).

4. *Rubin v. MF Global, Ltd.*, 634 F. Supp. 2d 459, 464 (S.D.N.Y. 2009).

5. Id. at 464-65 (quoting the complaint).

6. *Iowa Public Employees’ Ret. Sys.*, 2010 WL 3547602, at *1.

7. *Rubin*, 634 F.Supp.2d at 463-65 (quoting complaint), 468; see also *Iowa Public Employees’ Ret. Sys.*, 2010 WL 3547602, at *1.

8. *Rubin*, 634 F.Supp.2d at 469-73; *Iowa Public Employees’ Ret. Sys.*, 2010 WL 3547602, at *1-2. The district court dismissed, and plaintiffs did not appeal, claims that MF Global documents: 1)

misrepresented and omitted information regarding MF Global’s trading practices and 2) omitted information regarding MF Global’s failure to adjust its risk management system to account for Man Financial’s purchase of the Refco brokerage firm. *Rubin*, 634 F.Supp.2d at 469-70.

9. *Rubin*, 634 F.Supp.2d at 471-72.

10. Id. at 467 (quoting *Halperin v. eBanker USA.com Inc.*, 295 F.3d 352, 357 (2d Cir. 2002)).

11. Id. at 472-73. In the alternative the court held that plaintiffs’ risk management allegations failed to state a claim. Id. at 473-74. The court also dismissed plaintiffs’ claim under §15—which provides that individual control persons can be liable for violations of §§11 and 12(a)(2)—because such a claim was dependant on plaintiffs’ ability to plead a primary violation of §11 or §12(a)(2). Id. at 474.

12. Id. at 470.

13. *Iowa Public Employees’ Ret. Sys.*, 2010 WL 3547602, at *4.

14. Id.

15. Id. at *3, *5.

16. Id. at *4-5. In a footnote, the Second Circuit also rejected the district court’s alternative holding that plaintiffs’ risk management allegations failed to state a claim. Instead, the appellate court held that the district court should have drawn the relevant reasonable inference in plaintiffs’ favor. Id. at *4 n.13; see also *Rubin*, 634 F.Supp.2d at 473-74.

17. *Iowa Public Employees’ Ret. Sys.*, 2010 WL 3547602, at *5.

18. Id. (quoting *Pani v. Empire Blue Cross Blue Shield*, 152 F.3d 67, 74 (2d Cir. 1998)).

19. Id. (quoting complaint) (emphasis in appellate opinion).

20. Id. (internal quotation marks, brackets, and citation omitted).

21. Id.