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Second Circuit Holds That Omissions Regarding "Known Trends" May Support A Section 10(b) Claim, But Imposes Limitations On Such Claims

In *Stratte-McClure* v. *Morgan Stanley,* 2015 WL 136312 (2d Cir. Jan. 12, 2015), the Second Circuit held that omissions from Form 10-Q filings of information described in Item 303 of Regulation S-K—which includes information about "known trends or uncertainties" reasonably expected to have a material impact on revenues—may support a securities fraud claim under section 10(b) of the Securities Exchange Act of 1934. In so holding, the Second Circuit broke with the Ninth Circuit, which reached the opposite conclusion last October. However, the Second Circuit's decision indicates that plaintiffs are likely to face significant challenges when asserting claims of this type.

Background

Item 303 of Regulation S-K, 17 C.F.R. § 229.303, requires certain securities issuers to disclose specific information in registration statements. Among other things, issuers must "[d]escribe any known trends or uncertainties that have had or that the [issuer] reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." Item 303(a)(3)(ii). SEC forms require that the information described in Item 303 also be disclosed in issuers' Form 10-Q and 10-K filings.

In *Stratte-McClure*, plaintiffs asserted section 10(b) claims. They alleged, among other things, that between June and November 2007, Morgan Stanley failed to disclose a proprietary trade that gave the company significant exposure to the subprime sector. Plaintiffs alleged that Morgan Stanley was required under Item 303 to describe why, because of this exposure, the declining subprime market was reasonably expected to have a material unfavorable impact on Morgan Stanley's revenue.

The district court dismissed this claim. It agreed with plaintiffs that Morgan Stanley had a duty under Item 303 to disclose the subprime trade in Form 10-Q filings, meaning that its failure to do so was potentially actionable as an omission under section 10(b). However, the district court held that plaintiffs failed to plead a strong inference of scienter.

Second Circuit's Decision

The Second Circuit noted that "an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts." 2015 WL 136312, at *5 (quoting *In re Time*

Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993)). Such a duty "can derive from statutes or regulations that obligate a party to speak." *Id.* at *6. The Second Circuit reasoned that because Item 303 imposes an affirmative obligation on issuers to disclose certain information, a failure to disclose that information could constitute an omission sufficient to support a section 10(b) claim. *Id.* at *5-6. It observed that this holding was consistent with its previous decisions holding that failing to disclose Item 303 information in registration statements could support claims under the Securities Act of 1933. *Id.* at *6.

However, the Second Circuit then emphasized certain additional requirements for plaintiffs asserting section 10(b) claims based on a failure to disclose Item 303 information. In practice, these requirements—all of which can be raised by defendants at the motion to dismiss stage—are likely to impose significant limitations on such claims.

First, the court noted that as with any securities fraud claim under section 10(b), plaintiffs were required by the Private Securities Litigation Reform Act of 1995 to plead a "strong inference that the defendant acted with the required state of mind." Although this general requirement is well established, the Second Circuit's rigorous application of the requirement illustrates why it will often impose a significant burden for plaintiffs asserting omissions claims based on Item 303.

The Second Circuit held that to plead scienter, plaintiffs had to "allege that Defendants were at least consciously reckless regarding whether their failure to provide adequate Item 303 disclosures during the second and third quarters of 2007 would mislead investors about material facts." 2015 WL 136312, at *10. It held that plaintiffs had not done so. They alleged that Morgan Stanley created a task force to investigate selling some of the subprime position, but did not show that this task force realized during the relevant time that it was likely that the subprime position would deteriorate in value and could not be sold. *Id.* The court identified the "rigidity of Form 10-Q filing deadlines" as a reason why intent could not be inferred from the omission of more detailed information on those forms. *Id.* The court also cited its decision in *Kalnit* v. *Eichler*, 264 F.3d 131 (2d Cir. 2001), where it held that "where a complaint 'does not present facts indicating a *clear* duty to disclose' it does not establish '*strong* evidence of conscious misbehavior or recklessness,'" as required to plead scienter. 2015 WL 136312, at *10.

Second, the Second Circuit recognized the limited nature of the information required to be disclosed under Item 303. According to the court, plaintiffs had sufficiently alleged that Morgan Stanley's disclosures about subprime trends were inadequate because they were "generic, spread out over several different filings, and often unconnected to the company's financial position." 2015 WL 136312, at *9. However, the court also held that to satisfy Item 303, Morgan Stanley was not required to disclose the specific subprime position at issue. *Id.* Instead, 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 that if the trends came to fruition, the company faced trading losses that could materially affect its financial condition." *Id.*

Third, the court made clear that plaintiffs asserting claims that Item 303 information was omitted would need to meet section 10(b)'s requirement that the omission be material. It noted that, under *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), determining the materiality of a forward-looking disclosure, such as a disclosure concerning known trends, 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." 2015 WL 136312, at *6. The Second Circuit suggested that the *Basic* test for materiality is more onerous than the SEC's test for determining whether information should be reported under Item 303. *Id.* at *6-7. Accordingly, the court's decision means that a plaintiff asserting a section 10(b) omissions claim based on an alleged failure to disclose Item 303 information will need to satisfy both the SEC's test—in order to establish a duty to disclose that information under Item 303—and the *Basic* test—in order to show that the omission of that information violated section 10(b).

The Second Circuit expressly acknowledged that its central holding—that a section 10(b) omissions claim can be based on a failure to disclose Item 303 information—conflicts with the Ninth Circuit's decision in *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014). In that case, the Ninth Circuit held "that Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b–5." *Id.* at 1056. It reasoned that section 10(b) does not require all material information to be disclosed and has a more limited materiality test than Item 303. *Id.* at 1053-56. In the Ninth Circuit's view, it was therefore improper to allow broad Item 303 obligations to support claims under Section 10(b). *Id.*

Analysis

Although *Stratte-McClure* allows plaintiffs to assert section 10(b) claims based on the omission of Item 303 information, the restrictions recognized by the Second Circuit are likely to limit those claims significantly. In particular, the court's decision confirms that the requirement that plaintiffs plead a strong inference of scienter should continue to eliminate many such claims at the pleading stage. Allegations that information was improperly omitted under Item 303 will often turn on finely balanced questions about whether the trends were in fact known and significant and whether the disclosures were sufficient, particularly given the Second Circuit's confirmation that Item 303's disclosure obligations are not unlimited. Even if plaintiffs successfully show that disclosures were inadequate, in many cases—as in *Stratte-McClure* itself—plaintiffs will face significant difficulties showing that defendants intended to mislead investors by omitting information or were consciously reckless in that respect.

Stratte-McClure did not directly concern claims under the Securities Act, but such claims will also face difficulties when they, like the claims in *Stratte-McClure,* are based on the alleged omission of information about known trends. Because Item 303(a)(3)(ii) only requires disclosure of "known" trends, the Second Circuit has held that plaintiffs must show that those trends were actually known to the issuer, even for claims under the Securities Act that do not require scienter. *See Hutchinson* v. *Deutsche Bank Sec., Inc.*, 647 F.3d 479, 485, 486, 489 (2d Cir. 2011).

There is also now a clear circuit split between the Second Circuit and the Ninth Circuit on the issue of whether omitted Item 303 information can be the subject of a section 10(b) claim. It is unclear which interpretation other federal courts of appeals will adopt, but the issue may be ripe for potential review by the Supreme Court.

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