Second Circuit: Item 303 of Regulation S-K Imposes a Duty to Disclose under Section 10(b) and Rule 10b-5

The United States Court of Appeals for the Second Circuit held last week that a company's failure to comply with the MD&A disclosure requirements in Item 303 of Regulation S-K may provide the basis for a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").[1] Building on prior decisions, the Second Circuit expanded the scope of potential liability of companies for the omission of information regarding "known trends or uncertainties" that are reasonably expected to have a material effect on future revenues. However, the Court also confirmed that plaintiffs in Item 303 actions under Section 10(b) are required to plead, in compliance with the stringent pleading standards applicable to fraud claims, and prove, each element necessary to sustain an independent cause of action under Rule 10b-5, including, most notably, materiality and scienter. As the Court of Appeals Opinion demonstrates, when dealing in areas of judgment and opinion these burdens of pleading and proof are significant.

I. Regulatory Framework

Regulation S-K is a primary source of the disclosure requirements for the textual, non-financial statement portions of annual and periodic reports, registration statements, proxy materials and reports filed with the Securities and Exchange Commission ("SEC" or the "Commission") under the Exchange Act. Item 303 of Regulation S-K ("Item 303"), which governs the narrative explanation of the financial statements contained in the "Management's Discussion and Analysis" section, requires a discussion of "any known trends or uncertainties . . . that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[2] Registrants preparing this forward-looking information are instructed to "focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."[3] According to the Commission, a disclosure is to be considered "where a trend, demand, commitment, event or uncertainty is both [1] presently known to management and [2] reasonably likely to have material effects on the registrant's financial condition or results of operations."[4]

II. Factual Background and Procedural History[5]

In this putative securities fraud class action, the plaintiffs alleged, among other things, that Morgan Stanley (the "Company") failed to make a required disclosure under Item 303 in its Form 10-Qs in contravention of Section 10(b). The alleged "known trend or uncertainty" at issue arose from long positions that the Company had assumed in credit default swaps in the years leading up to the housing downturn. As these instruments were tied to collateralized debt obligations backed by mezzanine tranches of subprime residential mortgaged-backed

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[1] *Fjarde AP-Fonden v. Morgan Stanley*, No. 13-0627-cv, 2015 WL 136312 (2d Cir. Jan. 12, 2015), available at http://www.ca2.uscourts.gov/decisions/isysquery/886b8046-ef9e-47e7-8792-98e1d13cc707/1/doc/13-627_opn.pdf (the "Opinion").

[2] *Item* 303(a)(3)(ii).

[3] *Item* 303(a) instruction 3.

[4] Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, Exchange Act Release No. 26,831, Investment Company Act Release No. 16,961, 43 S.E.C. Docket 1330, 1989 WL 1092885, at *4 (May 18, 1989) (the "1989 Release").

[5] Unless otherwise indicated, the factual background and procedural posture is summarized from the facts set forth in the Opinion.

securities, the value of the Company's long swap position declined significantly over the course of 2007 when delinquencies and defaults on the underlying mortgages soared, causing a materially adverse impact on its revenues and placing downward pressure on the value of its stock.

According to the plaintiffs, the deteriorating state of the Company's long position in these credit default swaps, which had already required a write-down of $300 million as a result of the weakening housing market, constituted a known trend or uncertainty that the Company reasonably expected would have a material unfavorable impact on revenues. By failing to disclose the existence of the long position and that the Company was likely to incur additional significant losses on this position in the future, the plaintiffs continued, the Company made material omissions in its Form 10-Qs that rendered these reports misleading in violation of Section 10(b). The U.S. District Court for the Southern District of New York dismissed the claims on the pleadings for failure to state a claim, finding that although the Company had breached its duty under Item 303 to disclose the long position in its Form 10-Qs, the plaintiffs failed to plead sufficient allegations to support the underlying 10b-5 violation.[6]

III. The Court's Analysis

In a case of first impression in the Second Circuit, the Court of Appeals considered whether a failure to make a required disclosure under Item 303 in a Form 10-Q can serve as the basis for a securities fraud claim under Section 10(b) and Rule 10b-5. It is accepted that "an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts."[7] A duty is triggered where there is a "statute or regulation requiring disclosure" or a corporate statement that would otherwise be "inaccurate, incomplete, or misleading."[8] Plaintiffs alleged that each set of factors applied here, as Item 303 imposes disclosure requirements that seek to enhance the quality of financial disclosure and enable investors to see the company "through the eyes of management."[9] Referring to its earlier decisions in *Litwin v. Blackstone Group, L.P.*[10] and *Panther Partners Inc. v. Ikanos Communications, Inc.*,[11] which established that the required disclosures under Item 303 can in certain circumstances form the basis for liability under Sections 11 and 12(a)(2) of the Securities Act of 1933,[12] the Court concluded that Item 303 imposes a duty of disclosure that, in certain circumstances, can give rise to liability under Section 10(b) and Rule 10b-5.[13]

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[6] *Stratte-McClure v. Morgan Stanley*, No. 09-Civ.-2017, 2013 WL 297954 (S.D.N.Y. Jan. 18, 2013).

[7] *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993).

[8] *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992) (quoting *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1st Cir. 1990) (en banc)).

[9] 1989 Release, at *3.

[10] 634 F.3d 706 (2d Cir. 2011).

[11] 681 F.3d 114 (2d Cir. 2012).

[12] Section 11 imposes liability on issuers, underwriters and other signatories of an effective registration statement that "contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 12(a)(2) imposes liability for misstatements or omissions of material fact contained in a prospectus.

[13] *Fjarde*, 2015 WL 136312, at *5-*6. This approach conflicts with a prior decision of the United States Court of Appeals for the Ninth Circuit, which held in October that a violation of the disclosure requirements in Item 303 does not give rise to liability under Section 10(b) and Rule 10b-5. *See In re NVIDIA Corporation Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014).

Importantly, unlike a claim based on Sections 11 and 12(a)(2) that can be premised on allegations of negligence, the Court observed that a claim under Section 10(b) must allege fraud.[14] This has two important implications. First, the failure to make a required disclosure under Item 303 is not alone sufficient to state a claim. To proceed on the basis of Section 10(b), the plaintiff must allege (and ultimately establish) that each element necessary to sustain a cause of action under Rule 10b-5 is fulfilled.[15] Therefore, in addition to establishing that a corporation is subject to a duty to disclose a known trend or uncertainty under Item 303 and that a breach of this duty has occurred, a plaintiff must also sufficiently allege as to each defendant: (1) materiality, (2) scienter, (3) a connection between the omission and the purchase or sale of a security, (4) reliance upon the omission and (5) economic loss caused by that reliance.[16]

The second consequence of the underlying fraud claim is a greater burden on the plaintiff at the pleading stage. Whereas a plaintiff in non-fraud claims, which includes certain actions brought under Sections 11 and 12(a)(2) that do not sound in fraud, faces only the "short and plain statement" requirements of Rule 8(a) of the Federal Rules of Civil Procedure that "place[] a relatively minimal burden on a plaintiff,"[17] a plaintiff in a fraud claim must comply with the heightened pleading requirements of both Rule 9(b) and the Private Securities Litigation Reform Act.

Applying these standards, the Court assumed the plaintiffs' allegations that the Company's long position in credit default swaps that were linked to a rapidly deteriorating subprime mortgage market arguably constituted a known trend or certainty that, in light of the Company's earlier write-down and its continued exposure, was reasonably likely to cause trading losses that would materially affect its future revenues.[18] Because this trend allegedly caused the reported financial information "not to be necessarily indicative of future operating results or of future financial condition," Item 303 required the Company to disclose the manner in which that trend might materially impact the Company. While the Company's Form 10-Qs contained generalized information regarding the negative trends in the real estate markets and the potential negative effect on the Company's operations, the Court found such "generic cautionary language" falls short of the specific disclosure obligations of Item 303 that seek to facilitate a meaningful understanding and evaluation of the Company's prospects for the future.[19]

Although the plaintiffs had sufficiently alleged that the Company breached its Item 303 duty to disclose, the Court nevertheless affirmed the district court's dismissal on the basis that the complaint did not adequately allege each element of a 10b-5 securities fraud claim. The Court found no basis to infer the Company, in the exercise of judgment and in the expression of opinion, acted with "a state of mind approximating actual intent" to mislead investors in failing to make the Item 303 disclosure.[20] Falling victim to the heightened pleading standards of Section 10(b) claims, the complaint failed to include sufficient facts to give rise to "a strong reference of scienter."[21]

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[14] *See Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004) ("Fraud is not an element or a requisite to a claim under Section 11 or Section 12(a)(2). . . . [A] plaintiff need allege no more than negligence to proceed under Section 11 and Section 12(a)(2). . . .").

[15] *Fjarde*, 2015 WL 136312, at *7.

[16] *Id.*

[17] *Litwin*, 634 F.3d at 716 (quoting *Herman MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983)).

[18] *Fjarde*, 2015 WL 136312, at *8-*9.

[19] *Id.* at *9.

[20] *Id.* at *10.

[21] *Id.* at *4.

IV. Significance of the Decision

The *Fjarde* decision reinforces the importance of a robust and principled approach to MD&A disclosure. In contemplating the appropriate MD&A disclosure for registration statements and prospectuses, annual and periodic filings or any other relevant documents filed with the SEC, management should carefully consider whether there are trends, demands, commitments, events or uncertainties that may impact revenues and decrease the likelihood that past performance is indicative of future performance. This exercise is particularly useful given the uncertainties in the current economic climate. If this analysis leads to the determination that disclosure is required, management should craft detailed disclosure that goes beyond mere boilerplate.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Tyler O'Reilly at 011-44-20-7920-9819 or toreilly@cahill.com.