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## **CREATING A CLEAR CIRCUIT SPLIT, THE SECOND CIRCUIT HOLDS THAT FAILURE TO DISCLOSE KNOWN TRENDS OR UNCERTAINTIES UNDER ITEM 303 OF REGULATION S-K CREATES LIABILITY UNDER SECTION 10(B)**

To Our Clients and Friends:

On January 12, 2015, the United States Court of Appeals for the Second Circuit issued an unprecedented decision holding that a company's failure to disclose a known trend or uncertainty in its Form 10-Q filings, as required by Item 303 of SEC Regulation S-K, can give rise to liability under Section 10(b) of the Securities Exchange Act of 1934. *Stratte-McClure v. Morgan Stanley*, 2015 WL 136312 (2d Cir. Jan 12, 2015). The decision in *Stratte-McClure* is in direct conflict with the Ninth Circuit's recent ruling in *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014) ("*NVIDIA*"), the only other court of appeals decision to squarely address this issue. The Second Circuit's decision, while affirming the dismissal of the case against Morgan Stanley, potentially exposes issuers to greater liability under Section 10(b) for alleged failures to disclose known adverse trends and uncertainties as required by Item 303, in addition to the already existing exposure to regulatory claims arising out of such alleged disclosure violations. In light of *Stratte-McClure*, issuers should proceed with even greater care in crafting their MD&A disclosures, and in particular their disclosures related to known trends and uncertainties.

### **Summary of Item 303**

Item 303 of SEC Regulation S-K requires issuers to disclose, as part of management's discussion and analysis in various regulatory filings, "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." SEC guidance clarifies that a disclosure duty exists under Item 303 "where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation." Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 6835 (May 18, 1989).

Courts have held that the failure to comply with Item 303's known trends or uncertainties requirement in registration statements and prospectuses is actionable under Sections 11 and 12(a)(2) of the Securities Act of 1933. See *Panther Partners Inc. v. Ikanos Commc'ns, Inc.*, 681 F.3d 114 (2d Cir. 2012); *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293 (9th Cir. 1998). Whether a similar violation of Item 303 in a public filing such as a 10-K or 10-Q could give rise to liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, however, had not been squarely addressed by the federal courts of appeals until last year, when the Ninth Circuit held that

"Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." *NVIDIA*, 768 F.3d at 1056. However, in *Stratte-McClure*, the Second Circuit rejected the Ninth Circuit's holding and reasoning.

## **The *Stratte-McClure* Decision**

In *Stratte-McClure*, shareholders of Morgan Stanley filed a putative securities fraud class action against the company alleging, among other things, that Morgan Stanley violated Item 303's known trends and uncertainties requirement by omitting from its 2007 10-Qs information about a \$15.5 billion proprietary trade in the subprime mortgage market. In the trade, Morgan Stanley sold Credit Default Swaps (CDSs) to take a \$13.5 billion long position in Collateralized Debt Obligations (CDOs) that were backed by super-senior tranches of Residential Mortgage Backed Securities (RMBS). Concurrently, Morgan Stanley took a \$2 billion short position in CDOs backed by higher risk, mezzanine tranches of RMBS that would suffer losses sooner if the housing market worsened. The entire trade, therefore, bet that defaults in the subprime mortgage market would be significant enough to impair the value of higher risk RMBS tranches referenced by the short position but not significant enough to impair the value of the lower-risk tranches referenced by the long position. Plaintiffs alleged that as the housing market declined in 2007, Item 303 required Morgan Stanley to disclose the existence of its long position, that it had incurred losses on that position, and that it was likely to incur additional losses on the position in the future.

The district court granted Morgan Stanley's motion to dismiss, holding, among other things that Morgan Stanley had no duty to disclose its long position. After plaintiffs amended their complaint, the district court again dismissed the complaint but, this time, the court held--in light of the Second Circuit's decision in *Panther Partners*--that Morgan Stanley had a duty to disclose the long position in its 2007 10-Q filings as a known trend or uncertainty pursuant to Item 303. The district court dismissed the complaint because plaintiffs had failed to adequately plead a strong inference of scienter.

On appeal, the Second Circuit held that the "failure to make a required Item 303 disclosure in a 10-Q filing is . . . an omission that can serve as a basis for a Section 10(b) securities fraud claim." The Second Circuit reasoned that "omitting an item required to be disclosed on a 10-Q can render that financial statement misleading." The Second Circuit further concluded that the obligatory nature of Item 303 disclosures would lead a reasonable investor to interpret the absence of an Item 303 disclosure to imply the nonexistence of a material known trend or uncertainty. Thus, according to the appeals court, an issuer's silence would be rendered misleading if a known trend or uncertainty actually existed.

Despite the Second Circuit's ruling that a violation of Item 303 may also give rise to liability under Section 10(b), the court nevertheless made clear that a violation of Item 303 does not *automatically* create such liability, because the materiality standard for Item 303 is not as demanding as Rule 10b-5's materiality requirement. Therefore, under the Second Circuit's analysis, in order for Item 303 to provide a basis for a 10b-5 claim, the omission must also be material under the probability/magnitude test of *Basic v. Levinson*, 485 U.S. 224 (1998).

Turning to the facts of the case before it, the Second Circuit held that plaintiffs had adequately alleged an actionable omission. Plaintiffs contended that Morgan Stanley breached its Item 303 duty to disclose that the company faced a deteriorating subprime mortgage market that was likely to cause trading losses that would materially affect the company's financial condition. The Second Circuit agreed, pointing to allegations that starting in early 2007, Morgan Stanley employees supposedly made statements predicting a "meltdown" in the subprime market, significant risks to CDOs backed by RMBS, and ratings downgrades to CDO tranches. The Second Circuit concluded that the alleged trend was reasonably expected to have material effects on Morgan Stanley's financial position based on plaintiffs' allegations that Morgan Stanley had written down the long position by \$300 million by the beginning of the class period and had initiated stress tests and a task force to sell off assets that were at risk due to the collapse of the subprime market.

The Second Circuit also found that Morgan Stanley's disclosures about the deterioration of the real estate, credit and subprime markets and its potential negative effect on the company were too generic and unconnected to the company's financial position to satisfy Item 303. The court stated that Morgan Stanley was required to connect the known trends to its financial position. Specifically, the court found that Item 303 required Morgan Stanley to disclose that it had significant exposure to the deteriorating markets and that "if the trends came to fruition, the company faced trading losses that could materially affect its financial condition." Importantly, however, the Second Circuit explained that Morgan Stanley was *not* required to disclose the "particulars of its trading positions such as the Long Position," as the district court had held.

Finally, despite its holdings with respect to Item 303, the Second Circuit affirmed the district court's ruling that plaintiffs had failed to adequately allege scienter and affirmed the dismissal of the case.

## **The Circuit Split: The Ninth Circuit's Decision in *NVIDIA***

In concluding that Item 303 can give rise to Section 10(b) liability, the Second Circuit explicitly rejected the Ninth Circuit's contrary ruling in *NVIDIA*. In that case, plaintiffs brought a Section 10(b) claim against NVIDIA, a computer chip manufacturer, alleging that NVIDIA failed to disclose a defect in its computer chips that eventually resulted in the company taking a \$150 to \$200 million charge to cover warranty, repair, return, and replacement costs. *Id.* at 1050. Plaintiffs argued that disclosure was required pursuant to Item 303. *Id.* at 1054. The Ninth Circuit affirmed the district court's dismissal of the case, holding that Item 303's disclosure duty is not actionable under Section 10(b) and Rule 10b-5. *Id.* The Ninth Circuit reasoned that Section 10(b) and Rule 10b-5, unlike Sections 11 and 12(a)(2) of the Securities Act, have no "affirmative legal disclosure obligation" and "material information need not be disclosed unless omission of that information would cause other information that is disclosed to be misleading." *Id.* at 1055-56. The Ninth Circuit also explained that the materiality standards of Item 303 and Rule 10b-5 "differ considerably," meaning that disclosure duties are independent of each other and a plaintiff, to establish 10(b) liability, must independently allege a violation of that rule. *Id.* at 1055.

The stark conflict between the Second Circuit and Ninth Circuit rulings suggests that this issue may soon become ripe for Supreme Court review. In the meantime, issuers should heed the Second

Circuit's guidance that an issuer has a duty to connect known trends or uncertainties to the potential material impact on the issuer's financial condition. At a minimum, in light of the *Stratte-McClure* ruling, issuers should carefully consider whether to provide more detail on how any disclosed trends or uncertainties could harm the issuer's financial condition. Clearly, the Second Circuit has raised the bar considerably on issuers' disclosure duties under Section 10(b).



*Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, or the authors of this alert:*

*Jonathan C. Dickey - New York/Palo Alto (212-351-2399, 650-849-5370, [jdickey@gibsondunn.com](mailto:jdickey@gibsondunn.com))  
Noah F. Stern - Palo Alto (650-849-5212, [nstern@gibsondunn.com](mailto:nstern@gibsondunn.com))*

*Please also feel free to contact any of the following members of the Securities Litigation Practice Group Steering Committee:*

*Jonathan C. Dickey - Co-Chair, New York/Palo Alto (212-351-2399, 650-849-5370, [jdickey@gibsondunn.com](mailto:jdickey@gibsondunn.com))  
Robert F. Serio - Co-Chair, New York (212-351-3917, [rserio@gibsondunn.com](mailto:rserio@gibsondunn.com))  
Meryl L. Young - Co-Chair, Orange County (949-451-4229, [myoung@gibsondunn.com](mailto:myoung@gibsondunn.com))  
Thad A. Davis - Co-Chair, San Francisco (415-393-8251, [tadavis@gibsondunn.com](mailto:tadavis@gibsondunn.com))  
George H. Brown - Palo Alto (650-849-5339, [gbrown@gibsondunn.com](mailto:gbrown@gibsondunn.com))  
Jennifer L. Conn - New York (212-351-4086, [jconn@gibsondunn.com](mailto:jconn@gibsondunn.com))  
Ethan Dettmer - San Francisco (415-393-8292, [edettmer@gibsondunn.com](mailto:edettmer@gibsondunn.com))  
Barry R. Goldsmith - New York (212-351-2440, [bgoldsmith@gibsondunn.com](mailto:bgoldsmith@gibsondunn.com))  
Mark A. Kirsch - New York (212-351-2662, [mkirsch@gibsondunn.com](mailto:mkirsch@gibsondunn.com))  
Monica K. Loseman - Denver (303-298-5784, [mloseman@gibsondunn.com](mailto:mloseman@gibsondunn.com))  
Brian M. Lutz - New York (212-351-3881, [blutz@gibsondunn.com](mailto:blutz@gibsondunn.com))  
Jason J. Mendro - Washington, D.C. (202-887-3726, [jmendro@gibsondunn.com](mailto:jmendro@gibsondunn.com))  
Alex Mircheff - Los Angeles (213-229-7307, [amircheff@gibsondunn.com](mailto:amircheff@gibsondunn.com))  
Wayne Smith - Orange County (949-451-4108, [wsmith@gibsondunn.com](mailto:wsmith@gibsondunn.com))  
Robert C. Walters - Dallas (214-698-3114, [rwalters@gibsondunn.com](mailto:rwalters@gibsondunn.com))  
Aric H. Wu - New York (212-351-3820, [awu@gibsondunn.com](mailto:awu@gibsondunn.com))*

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