

# SHINING THE LIGHT A LITTLE BRIGHTER: SHOULD ITEM 303 SERVE AS A BASIS FOR LIABILITY UNDER RULE 10b-5?

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*This Note discusses a securities disclosure issue stemming from a split between the Second Circuit and the Ninth Circuit. The question presented is whether failure to comply with a disclosure requirement created by Item 303 of Regulation S-K can provide a basis for liability under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The Ninth Circuit held that such violation does not provide a basis for liability. Conversely, in *Stratte-McClure v. Morgan Stanley*, the Second Circuit explicitly disagreed with the Ninth Circuit and concluded that this violation may serve as a basis for liability. This Note examines the rationales behind each decision, as well as the rationales behind disclosure regulations more generally, and ultimately concludes that Item 303 violations should serve as a basis for 10b-5 liability, as long as all of the remaining requirements of a 10b-5 claim are met.*

INTRODUCTION.....	336
I. SECURITIES REGULATION: DEVELOPMENT, DISCLOSURE, AND DECREES.....	338
A. <i>Emergence of Disclosure Regulations</i> .....	338
1. 1934–1960s: Creation and Implementation .....	339
2. 1964: Expansion.....	341
3. 1982: Integration.....	341
4. Recent Regulations: Highlighting a Recurring Pattern.....	342
B. <i>Why Disclose at All?</i> .....	343
C. <i>Relevant Rules and Regulations</i> .....	345
1. Section 10(b) and Rule 10b-5 .....	345
2. Sections 11 and 12(a)(2) of the 1933 Act .....	347
3. Item 303: Management’s Discussion and Analysis of Financial Condition and Results of Operations.....	348

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II. THE CIRCUIT SPLIT: WHETHER VIOLATIONS OF ITEM 303 MAY SERVE AS A BASIS FOR LIABILITY UNDER RULE 10b-5 .....	350
A. <i>Paving the Road for the Rulings: Qualification and Analogy</i> .	350
1. <i>Oran v. Stafford: Leaving the Door Ajar</i> .....	350
2. <i>Litwin v. Blackstone Group, L.P.</i> .....	351
3. <i>Panther Partners Inc. v. Ikanos Communications, Inc.</i> .....	353
B. <i>The Ninth Circuit: Closing the Door to Liability</i> .....	354
C. <i>The Second Circuit: Rejecting NVIDIA and Opening the Door to Liability</i> .....	356
D. <i>Summary of the Circuit Split</i> .....	359
III. THE SUPREME COURT SHOULD ADOPT <i>STRATTE-MCCLURE</i> .....	360
A. <i>Materiality: The Connection Between Separate Standards and Related Roles</i> .....	360
B. <i>Hypotheticals: Relationship Between Item 303 and Rule 10b-5</i> .....	361
C. <i>Cases: Oran, Panthers Partners, and Litwin</i> .....	362
D. <i>The Role of Remedies</i> .....	363
E. <i>The Broader Impact</i> .....	364
CONCLUSION .....	366

#### INTRODUCTION

Information is one of the most valuable tools in society. Not only does it foster intelligent communication and knowledgeable decision making, it also reduces the risk of inefficiency and waste. Information can, however, also be overwhelming and burdensome.<sup>1</sup> In a time when information is more accessible than ever, it is vital to focus attention on that information which is most useful. This becomes especially important when evaluating securities regulation.

From the beginning, securities regulation has been focused on disclosure.<sup>2</sup> While issuers were often willing to disclose information that would attract investors, many felt that regulation was needed to ensure that these investors were not being deceived or misled.<sup>3</sup> Over time, Congress and the Securities and Exchange Commission (SEC) have developed and modified many different regulations in an attempt to ensure a fair and efficient securities markets.<sup>4</sup> One such regulation is Item 303 of Regulation S-K (“Item 303”).<sup>5</sup> The SEC has long viewed Item 303 as an important and

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1. See Mary Jo White, Chair, SEC, The Path Forward on Disclosure, Speech at the National Association of Corporate Directors—Leadership Conference 2013 (Oct. 15, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370539878806> (noting concern about the possibility that current disclosure obligations can lead to an “information overload”) [<https://perma.cc/ND3P-YBCP>].

2. See *infra* Part I.A.

3. See *infra* Part I.A.

4. See *infra* Part I.A.

5. 17 C.F.R. § 229.303(a)(3)(ii) (2016).

unique opportunity for investors to get a glimpse of the company “through the eyes of management.”<sup>6</sup>

While rules and regulations are important, they are arguably ineffective without an appropriate enforcement mechanism.<sup>7</sup> Thus, a court’s decision that a particular violation may or may not serve as a basis for liability will have a significant impact on securities regulation and, consequently, the market as a whole. A recent split between the Second Circuit and the Ninth Circuit provides a vivid example of the implications of a court’s decision in the securities realm.<sup>8</sup> This split concerns whether a violation of Item 303 may serve as a basis for liability under section 10(b) of the Securities Exchange Act of 1934<sup>9</sup> and SEC Rule 10b-5.<sup>10</sup>

Deciding whether a violation of Item 303 is actionable under section 10(b) and Rule 10b-5 will have a great impact on a variety of players in the securities markets.<sup>11</sup> For example, the risk of liability will encourage issuers to disclose thorough and adequate details concerning how “trends or uncertainties could harm the issuer’s financial condition.”<sup>12</sup> In making this decision, however, it also is important to consider what safeguards are in place to protect against a flood of information and (unnecessary) litigation.<sup>13</sup>

Part I of this Note briefly discusses the development of securities regulation and the specific regulations pertinent to this analysis. It also analyzes the extent to which disclosure obligations achieve the goals underlying their creation and how they have evolved to meet new issues. In

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6. Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835, Exchange Act Release No. 26,831, 54 Fed. Reg. 22,427, 22,428 (May 24, 1989) [hereinafter 1989 SEC Release] (quoting Management’s Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, Exchange Act Release No. 24,356, 52 Fed. Reg. 13,715, 13,717 (Apr. 24, 1987) [hereinafter 1987 SEC Release]).

7. However, critics of mandatory disclosure argue that voluntary disclosure, regulated by market forces, is a much more efficient way of ensuring an optimal level of disclosure. See Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 689–91 (1999).

8. See generally Jonathan C. Dickey & Noah F. Stern, *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)*, GIBSON, DUNN & CRUTCHER LLP (Jan. 22, 2015), <http://www.gibsondunn.com/publications/Documents/Second-Circuit--Failure-to-Disclose-Known-Trends-or-Uncertainties-Under-Item-303--Regulation%20S-K-Creates-Liability.pdf> [https://perma.cc/5L6G-EZSQ].

9. 15 U.S.C. § 78j (2012).

10. 17 C.F.R. § 240.10b-5; see *infra* Part II. Although recent literature has addressed this issue, this Note will expand upon the issues and provide a unique perspective on rationales that underlie this Note’s proposed resolution. See generally Denise Voigt Crawford & Dean Galaro, *A Rule 10b-5 Private Right of Action for MD&A Violations?*, 43 SEC. REG. L.J. 1 (2015).

11. See *infra* Part III.E.

12. See Dickey & Stern, *supra* note 8, at 4.

13. See Susanna M. Buerge, Andrew J. Ehrlich & Audra J. Soloway, *Keeping Current: Second Circuit Holds That Omissions Regarding “Known Trends” May Support a Section 10(b) Claim, but Imposes Limitations*, BUS. L. TODAY 2 (Feb. 2015), <http://www.americanbar.org/content/dam/aba/publications/blt/2015/02/full-issue-201502.authcheckdam.pdf> [https://perma.cc/KES7-LHPJ].

addition, it explores the debate concerning whether mandatory disclosure is the best way to regulate securities.<sup>14</sup> While most agree that accurate information is crucial to the decision-making process, there is some dispute as to whether mandatory disclosure is the best way to provide investors with the optimal amount. Finally, it discusses a few of the regulations that play an important role in the circuit split discussed in Part II.

Part II then examines a recent conflict that has arisen among circuit courts. Specifically, this part discusses whether a failure to comply with a disclosure requirement created by Item 303 provides a basis for liability under section 10(b) and Rule 10b-5. The two circuits to squarely address this issue have reached opposite conclusions. This part details the rationales offered by each decision, as well as how the courts have applied those rationales to the facts of each case.

Part III of this Note explains why the U.S. Supreme Court should endorse the Second Circuit's conclusion in *Stratte-McClure v. Morgan Stanley*<sup>15</sup> that a violation of Item 303 may serve as a basis for liability under Rule 10b-5. First, it examines the materiality requirements of Item 303 and Rule 10b-5, independent of the two main cases. Next, it discusses why the Second Circuit appropriately interpreted and applied the relevant precedent. Finally, it explores the impact that such liability will have on the various players of the securities markets, including the companies that produce the information and the investors who rely on it.

#### I. SECURITIES REGULATION: DEVELOPMENT, DISCLOSURE, AND DECREES

This Note begins by discussing the evolution of the securities regime implemented in the United States. Part I.A explores the evolution of mandatory disclosures and securities regulations more generally. Next, Part I.B briefly discusses some of the key arguments made in the debate surrounding the use of disclosure obligations. Finally, Part I.C takes a closer look at several regulations examined by the Ninth Circuit and the Second Circuit in resolving the conflict described in Part II.

##### A. *Emergence of Disclosure Regulations*

Beginning in the 1930s, the federal government decided to use disclosure as the primary means of regulating the securities markets. Over time, although the specifics of various regulations have changed, the basic concept of using mandatory disclosure has remained the touchstone of this regime. This section will examine the development of securities law and the policies behind its implementation.

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14. This includes whether, or to what extent, disclosure obligations protect investors and promote an efficient market.

15. 776 F.3d 94 (2d Cir. 2015).

### 1. 1934–1960s: Creation and Implementation

The stock market crash of October 1929 and the ensuing depression prompted calls for reform from the government and society as a whole.<sup>16</sup> The years leading up to this crash were filled with “general prosperity,” which motivated the first wave of “relatively unsophisticated small scale investors” to enter the stock market.<sup>17</sup> After the crash, Congress determined that abuses in the securities markets, such as fraud and deliberate manipulation of stock prices, were partially to blame.<sup>18</sup> Thus, one of Congress’s main priorities was to find a way to protect vulnerable investors.<sup>19</sup>

Concluding that both state regulation and self-regulation were ineffective, legislators began to direct their attention toward reform.<sup>20</sup> Although many wanted a system based on government oversight, President Franklin Delano Roosevelt promoted a system based on disclosure.<sup>21</sup> Not only did disclosure impede illegal activity, but it “also tended to discourage conduct which, although technically legal, was not entirely consistent with the highest fiduciary standards of behavior.”<sup>22</sup> In addition, this form of regulation required limited government intervention.<sup>23</sup>

These ideas were articulated in Congress’s enactment of the Securities Act of 1933 (“the 1933 Act”) and the Securities Exchange Act of 1934 (“the 1934 Act”). The 1933 Act established requirements pertaining to the issuance of new securities.<sup>24</sup> Barring a specific exemption, a new security could be offered for sale only after the offeror filed a registration statement with the SEC and such statement became effective.<sup>25</sup> The SEC, however, had no authority to evaluate the quality of the underlying securities.<sup>26</sup> If the registration statement contained the required information, and this information was not inadequate or misleading, it became effective at the end of the twenty-day waiting period.<sup>27</sup> After the registration statement

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16. Alison G. Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 316–17 (1974).

17. *Id.* at 316.

18. *See id.* at 316–17.

19. *See id.* (noting that many small investors had been financially harmed by their investments).

20. *See id.* at 318.

21. *See* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 132 (1973).

22. Anderson, *supra* note 16, at 319.

23. *See id.*

24. *See id.* at 321.

25. *See id.*

26. *See id.* at 322. In fact, the 1933 Act made it a crime for the SEC to comment on the merits or truthfulness of a registration statement or offered security. *See id.* at 322 n.50.

27. *See id.* at 322. Although the statute listed specific requirements, it also gave the SEC broad discretion to vary these requirements. *Id.*

became effective, the registrant could begin to sell securities, but was required to send a detailed prospectus<sup>28</sup> to all purchasers.<sup>29</sup>

The 1933 Act also was designed to regulate transactions within the securities markets.<sup>30</sup> In addition to providing explicit prohibitions on certain actions, the 1933 Act created private remedies for individuals who bought securities from sellers who failed to provide proper disclosure or used deceptive statements.<sup>31</sup> Legislators hoped that these rules simultaneously would increase the amount of accurate and useful information in the marketplace and protect against fraud.<sup>32</sup>

The 1934 Act was intended to extend the regulations of the 1933 Act to existing securities.<sup>33</sup> Issuers of preexisting securities were required to register these securities with the SEC and, in addition, file periodic reports to ensure the information remained current.<sup>34</sup> Although issuers were not required to send these periodic reports directly to investors, proponents of a mandatory disclosure system believed that small investors would still benefit from such disclosure.<sup>35</sup> Despite recognizing that average investors would not be able to effectively utilize the detailed information in these disclosures, proponents believed that investors would benefit from the advice given and decisions made by those who could use the information effectively.<sup>36</sup>

It was immediately apparent, however, that these statutes were not well suited to protect small investors.<sup>37</sup> Despite Congress's hope, these regulations were better equipped to disseminate information than to protect unsophisticated investors.<sup>38</sup> Although these regulations increased the accessibility of reliable information, this information was not ideal for efficient investment analysis.<sup>39</sup> Those who wished to comply often were stymied by "uncertain rules and *ad hoc* pronouncements," which resulted in unhelpful "boilerplate" disclosures.<sup>40</sup> In addition, issuers often

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28. *Id.* As articulated by the U.S. Supreme Court, the term "prospectus" describes "documents related to public offerings by an issuer or its controlling shareholders." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995).

29. *See* Anderson, *supra* note 16, at 322. This prospectus was to contain all of the information that was in the registration statement.

30. *Id.*

31. *Id.*; *see also* William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 *YALE L.J.* 171, 171-72 (1933) (noting that a "slow educational process" must take place before the novice investors can benefit from these disclosures).

32. *See* Anderson, *supra* note 16, at 323.

33. *Id.* at 327.

34. *Id.*

35. *Id.* at 328-30.

36. *See id.* at 329-30. It was believed that this effective use of information would result in more accurate market prices.

37. *See id.*

38. *See id.* at 321.

39. *See id.* at 342; *see also* Homer Kripke, *The Myth of the Informed Layman*, 28 *BUS. LAW.* 631, 632 (1973) (arguing that some disclosures were too sophisticated for the layman, yet too elementary to be useful for experts).

40. *See* Anderson, *supra* note 16, at 342.

promulgated unnecessarily pessimistic disclosures, with the hope of protecting against the unrealistic expectations advertised by promoters.<sup>41</sup>

## 2. 1964: Expansion

In 1964, the reach of the 1934 Act was expanded to cover the over-the-counter market.<sup>42</sup> This greatly enhanced the SEC's ability to protect investors in the arena where most securities transactions took place: the trading markets.<sup>43</sup> Before this expansion, the SEC's ability to enact strict disclosure regulations was limited by the ability of companies to avoid compliance by simply delisting.<sup>44</sup>

Although many government officials still advocated for protecting the novice investor from fraud, focus began to shift toward making required disclosure more useful for sophisticated investment analysis.<sup>45</sup> As the securities markets became increasingly complicated, the demand for professional analysts and financial managers increased.<sup>46</sup> At the same time, the demand for more sophisticated information also increased.<sup>47</sup> One way the SEC accommodated the latter demand was to relax some of the "stringent requirements that disclosure be negative in tone and limited to 'hard facts.'"<sup>48</sup>

The goal of protecting the small investor, however, was not totally abandoned. Issuers consistently were urged to make changes to their prospectuses, such as reducing length and complexity, to make them more palatable to unsophisticated traders.<sup>49</sup> In addition, issuers were required to put summaries in each prospectus to help protect investors from making bad investments.<sup>50</sup> While simplifying these disclosures may have benefited novice investors, it also may have made these disclosures less useful to experts.<sup>51</sup>

## 3. 1982: Integration

For over forty years, the 1933 Act and the 1934 Act were administered independently, which resulted in duplicative obligations that were required

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41. *See id.*

42. *Id.* at 343; *see also* Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1341 (1966) (discussing how the 1964 amendments made the disclosure requirements of the 1934 Act "applicable to a much larger category of issuers").

43. *See* Anderson, *supra* note 16, at 343.

44. *See id.*

45. *See id.* at 343–44.

46. *See id.* at 343.

47. *See id.*

48. *See id.* "Hard Facts" are the opposite of "soft information." *Id.* at 337–38. "Soft information" constitutes information that is not "susceptible [to] objective verification," such as statements about the future. *Id.* at 337 n.126 (citing Carl W. Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972)).

49. *See id.* at 351.

50. *See id.* at 351–52.

51. *See* Kripke, *supra* note 39, at 632.

to be satisfied in different ways.<sup>52</sup> Thus, during the 1970s, the SEC began focusing its attention on developing an integrated system that would reduce redundancy and foster consistency.<sup>53</sup>

Regulation S-K was implemented as part of this integrated disclosure system and contains many “substantive disclosure requirements,” including Item 303.<sup>54</sup> Specifically, Regulation S-K contains the requirements for the nonfinancial disclosures contained in documents filed with the SEC.<sup>55</sup> While the amount of detail required by Regulation S-K may seem overwhelming, it is qualified by the concept of materiality.<sup>56</sup>

#### 4. Recent Regulations: Highlighting a Recurring Pattern

Throughout history, financial crises have been catalysts for significant reforms.<sup>57</sup> One such reform is the Sarbanes-Oxley Act of 2002<sup>58</sup> (“Sarbanes-Oxley”), which was enacted in response to major scandals, such as those involving Enron and WorldCom.<sup>59</sup> Congress hoped that this legislation would “restore investor confidence by improving corporate financial reporting.”<sup>60</sup> Congress’s approach, however, was unique in that the focus was not disclosure obligations but, rather, substantive regulations.<sup>61</sup>

Soon after Congress enacted Sarbanes-Oxley, however, the U.S. economy experienced the most devastating crisis since the Great Depression.<sup>62</sup> To protect against another such depression, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection

52. See John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1158 (1995).

53. See *id.*

54. See STAFF OF THE U.S. SEC. & EXCH. COMM’N, REPORT ON REVIEW OF DISCLOSURE REQUIREMENTS IN REGULATION S-K 8–10 (Dec. 2013), <http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf> [<https://perma.cc/NU5C-CDEK>].

55. Roberta S. Karmel, *Disclosure Reform—The SEC Is Riding Off in Two Directions at Once* 4 (Brooklyn Law Sch. Legal Studies, Working Paper No. 419, 2015), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2650719&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2650719&download=yes) [<https://perma.cc/6CR5-2R8J>].

56. See *id.* at 4–5. Materiality plays an important role in the circuit split that is the focus of this Note and is discussed in further detail below.

57. See *id.* at 6.

58. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

59. See Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 235 (2009); Valerie Watnick, *Whistleblower Protections Under the Sarbanes-Oxley Act: A Primer and a Critique*, 12 FORDHAM J. CORP. & FIN. L. 831, 831 (2007).

60. Beverley H. Earle & Gerald A. Madek, *The Mirage of Whistleblower Protection Under Sarbanes-Oxley: A Proposal for Change*, 44 AM. BUS. L.J. 1, 4 (2007) (quoting JOHN BOSTLEMAN, *Background: Twelve Months Leading Up to the SOA*, in THE SARBANES-OXLEY DESKBOOK 2–32 (2004)). Another major goal of Sarbanes-Oxley, the protection of whistleblowers, see *id.*, is not discussed in this Note.

61. See Romano, *supra* note 59, at 232 (noting that only a limited number of provisions in Sarbanes-Oxley contained disclosure requirements).

62. See Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. ON REG. 91, 92 (2012).



Act<sup>63</sup> (“Dodd-Frank”). Dodd-Frank changed the way institutions were supervised by considering the functions of each institution rather than the specified corporate form.<sup>64</sup> In addition, Dodd-Frank instituted new agencies to collect data and ensure transparency throughout financial markets.<sup>65</sup> However, before the SEC was able to execute fully the expansive regulations required under Dodd-Frank, Congress passed the Jumpstart Our Business Startups Act<sup>66</sup> (“JOBS Act”). Unlike Sarbanes-Oxley and Dodd-Frank, the JOBS Act reduced the number of requirements imposed on certain companies.<sup>67</sup>

This brief, partial history is meant to illustrate a pattern of “episodic expansion of regulatory scope within the disclosure regime.”<sup>68</sup> The next section of this Note explores a debate that often accompanies these reforms.

### B. Why Disclose at All?

Even though disclosure remains the focus of securities regulation, the debate surrounding its use is still thriving. Not only are there questions about mandatory disclosure generally, but there are also disputes about what level of disclosure is most efficient.<sup>69</sup> This section briefly highlights some of the arguments on both sides of this contentious debate.

As previously discussed, disclosure rules were implemented with a variety of policy goals in mind.<sup>70</sup> A few of the main justifications for such rules are encouraging confidence in the markets, protecting unsophisticated investors, and ensuring investors receive adequate and accurate information.<sup>71</sup> By increasing the supply of accurate information, mandatory disclosure promotes efficiency and profitability throughout the securities markets.<sup>72</sup>

Since information has many qualities of a public good,<sup>73</sup> it tends to be underprovided and not adequately verified.<sup>74</sup> Thus, it is argued that mandatory disclosure is needed to prevent companies from trying to avoid

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63. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

64. See Barr, *supra* note 62, at 92.

65. See *id.*

66. Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

67. Lawrence A. Hamermesh & Peter I. Tsoflias, *An Introduction to the Federalist Society’s Panelist Discussion Titled “Deregulating the Markets: The JOBS Act,”* 38 DEL. J. CORP. L. 453, 454 (2013).

68. Romano, *supra* note 59, at 231.

69. See White, *supra* note 1.

70. See *supra* Part I.A.1.

71. Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 692–96 (1984). Easterbrook and Fischel find these rationales unconvincing and present alternative justifications, including protecting against interstate exploitation and limiting the costs of a common law system. See *id.* at 696–99.

72. See *id.* at 673.

73. A public good is a good from which others can consume and benefit, whether or not they contributed to the costs of acquiring it. See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 725 (1984).

74. See *id.* at 722.

liability by simply staying silent.<sup>75</sup> Mandatory disclosure also reduces the fear that rivals will get a “free ride” or a “competitive advantage” from such disclosure.<sup>76</sup> In addition, since those who spend the time and resources to thoroughly evaluate a potential investment tend to be undercompensated, a regulatory response may be justified to correct the market’s failure to produce the “socially optimal supply of research.”<sup>77</sup>

Those in favor of mandatory disclosure also argue that fostering collectivization helps minimize social waste caused by investors misallocating resources in pursuit of trading gains.<sup>78</sup> This collectivization also helps preserve resources by protecting against unnecessary duplication.<sup>79</sup> Rather than duplicating research, these resources could be used in other ways, such as expanding investment.<sup>80</sup>

There is, however, some debate over whether mandatory disclosure rules are necessary to facilitate the spread of information.<sup>81</sup> One argument is that the best disclosure policy is the one utilized by corporations in the absence of regulations.<sup>82</sup> If disclosure will assist investors, then the company will do so because it will lead to increased profits.<sup>83</sup>

There also are arguments that mandatory disclosure is not necessary to combat the free rider problem discussed above.<sup>84</sup> Although others benefit from the efforts put forth by informed traders,<sup>85</sup> these efforts do not go unrewarded. There are benefits, such as discounts on accurate valuations, available to those who first acquire information.<sup>86</sup>

In addition, there are concerns that too many disclosure requirements might actually hurt the market by forfeiting quality for quantity.<sup>87</sup> As the amount of detail required to satisfy disclosure obligations increases, investors may be so inundated with information that they are unable to accurately ascertain what information is relevant.<sup>88</sup>

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75. See Easterbrook & Fischel, *supra* note 71, at 680.

76. See *id.* at 686.

77. See Coffee, Jr., *supra* note 73, at 725–28.

78. See *id.* at 722.

79. See Easterbrook & Fischel, *supra* note 71, at 682.

80. See *id.* at 675.

81. See *id.* at 680–85.

82. See Benston, *supra* note 21, at 133. One rebuttal to this, however, is that it “assumes much too facilely that manager and shareholder interests can be perfectly aligned.” Coffee, Jr., *supra* note 73, at 722.

83. See Easterbrook & Fischel, *supra* note 71, at 682.

84. See *id.* at 694.

85. These efforts will be reflected in the market prices, which fluctuate until they adequately represent the information known at that time. See *id.*

86. See *id.* Because mandatory disclosure will still not provide the passive investors with the information in time to benefit from these bargains, it is argued that another rationale is needed to promote this policy. See *id.*

87. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

88. See White, *supra* note 1.

### C. Relevant Rules and Regulations

This part examines several rules and regulations that play a significant role in the conflict discussed in Part II. Part I.C.1 discusses section 10(b) and Rule 10b-5. It also examines the different components of claims brought under Rule 10b-5, focusing particularly on materiality. Part I.C.2 briefly discusses sections 11 and 12(a)(2), which are pertinent to the analysis of the circuit split discussed in Part II. Finally, Part I.C.3 analyzes Item 303. Specifically, it examines the textual requirements, as well as SEC guidance on how to meet those requirements.

#### 1. Section 10(b) and Rule 10b-5

Under section 10(b), it is illegal “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors.”<sup>89</sup> As noted by the Supreme Court, this section was intended to be a comprehensive provision that protected against a variety of deceptive practices, including fraud.<sup>90</sup> This section also endows the SEC with the power to prohibit such conduct in securities transactions.<sup>91</sup>

Consequently, the SEC implemented section 10(b) via Rule 10b-5, which states that

[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>92</sup>

In order to bring a successful Rule 10b-5 claim, a plaintiff must establish six elements: “(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.”<sup>93</sup>

While explicit misstatements are relatively easy to identify, it is more difficult to determine whether a company’s silence may expose it to liability. The Supreme Court shed some light on this issue by declaring that

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89. 15 U.S.C. § 78j (2012).

90. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203–04 (1976).

91. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952).

92. 17 C.F.R. § 240.10b-5 (2016).

93. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008). This Note focuses on the first element, while briefly discussing the other five.

“[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5.”<sup>94</sup> It did not, however, explicitly describe what was required to create a duty to disclose.<sup>95</sup> Although neither section 10(b) nor Rule 10b-5 creates an affirmative obligation to disclose *all* material information, disclosure is required when “a material fact [is] necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”<sup>96</sup>

A key term in the first element of a Rule 10b-5 claim is “materiality.”<sup>97</sup> In *Basic Inc. v. Levinson*,<sup>98</sup> the Supreme Court clarified the materiality standard for Rule 10b-5 by explicitly stating that “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”<sup>99</sup> *Basic* also clarified that, if information is speculative or contingent, materiality depends on “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.”<sup>100</sup>

The Supreme Court, however, also warned against treating investors like children who are unable to comprehend the probable consequences of typical business interactions.<sup>101</sup> It was concerned that if companies started overdisclosing to protect against liability, the rule would end up harming the very investors it was designed to protect.<sup>102</sup> Thus, to prevent the rule from generating too great of an influx of information, the Supreme Court explicitly stated that it was “careful not to set too low a standard of materiality.”<sup>103</sup>

The other contours of the remaining five elements similarly have been defined through jurisprudence. For example, the scienter requirement of Rule 10b-5 has been read by most courts to require that the defendant knowingly or recklessly disseminated a disclosure that was false or misleading.<sup>104</sup> The dominant approach to analyzing recklessness is to apply a subjective standard.<sup>105</sup> The Supreme Court also confirmed that to bring a private action under Rule 10b-5, plaintiffs must have actually bought or

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94. *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

95. *See In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1054 (9th Cir. 2014).

96. 17 C.F.R. § 240.10b-5.

97. *See id.*

98. 485 U.S. 224 (1988).

99. *Id.* at 231. This language was taken from another Supreme Court case that arose under section 14(a) of the 1934 Act and Rule 14a-9. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

100. *Basic*, 485 U.S. at 238 (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

101. *See id.* at 234.

102. *See id.* at 231.

103. *Id.*

104. *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 126 (1997).

105. *See id.* at 126 n.83 (“There must be some awareness of the risk that the disclosure is false or misleading, not simply an extreme departure from the standard of care.”).

sold securities.<sup>106</sup> With regard to reliance, the Supreme Court has applied the fraud-on-the-market theory.<sup>107</sup> This theory is based on the assumption that investors who purchase securities rely on the integrity of market prices, which reflect most publicly available information.<sup>108</sup> Thus, in a Rule 10b-5 action, it may be presumed that these investors relied on public disclosures that contained material misrepresentations or omissions.<sup>109</sup> Finally, to bring a successful action under Rule 10b-5, plaintiffs must also establish “that the defendant’s deceptive conduct caused their claimed economic loss.”<sup>110</sup>

Although Rule 10b-5 does not expressly provide for a private right of action, courts have crafted an implied right of recovery for individual investors.<sup>111</sup> Damages in these cases mostly have consisted of actual damages, rescission, and injunctive relief.<sup>112</sup>

## 2. Sections 11 and 12(a)(2) of the 1933 Act

In analyzing the connection between Item 303 and Rule 10b-5, the Ninth Circuit and the Second Circuit disagree over whether it is appropriate to consider the relationship between Item 303 and sections 11 and 12(a)(2) of the 1933 Act.<sup>113</sup>

Although sections 11 and 12(a)(2) establish bases for liability in connection with the purchase of securities, each rule is limited in scope to specific types of transactions.<sup>114</sup> While section 11 applies to sales of securities in connection with public offerings, section 12(a)(2) covers transactions made via instruments of interstate commerce.<sup>115</sup> Although the requirements for claims brought under sections 11 and 12(a)(2) are not identical to those brought under Rule 10b-5, there is some overlap—the most significant being the focus on materiality.<sup>116</sup>

Both section 11 and section 12(a)(2) state that disclosure of untrue material statements constitutes a basis for liability.<sup>117</sup> In addition, both sections impose liability for omissions of material facts necessary to prevent disclosed statements from becoming misleading.<sup>118</sup> Not only is the language similar to that of Rule 10b-5, but courts also have applied the

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106. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (noting desire to prevent “vexatious litigation” as one of its rationales).

107. See *Basic*, 485 U.S. at 229.

108. See *id.* at 245.

109. See *id.* at 246–47.

110. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804, 807 (2011).

111. See Nicholas R. Weiskopf, *Remedies Under Rule 10b-5*, 45 ST. JOHN’S L. REV. 733, 735 (1971). The first decision to find an implied right of action was *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

112. See 15 U.S.C. § 78bb(a) (2012); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 803 (2d Cir. 1969).

113. See *infra* Part II.

114. See 15 U.S.C. §§ 77k(a), 77l(a)(2).

115. See *id.*

116. See *supra* Part I.C.1.

117. See 15 U.S.C. §§ 77k(a), 77l(a)(2).

118. See *id.*

same standard for materiality in all three causes of action.<sup>119</sup> However, a defendant will not be liable if it can prove that the purchaser was aware of the material untruth or omission.<sup>120</sup>

Unlike Rule 10b-5, these rules explicitly establish private rights of action.<sup>121</sup> However, both provisions are limited in scope and impose stringent liability standards.<sup>122</sup> In addition, plaintiffs alleging violations under either section 11 or 12(a)(2) do not have to prove scienter, reliance, or causation of damages.<sup>123</sup>

### 3. Item 303: Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 303 states that the registrant will "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."<sup>124</sup> Instruction 3 to this paragraph states that "[t]he discussion and analysis shall 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."<sup>125</sup> This disclosure is called Management's Discussion and Analysis (MD&A).

The SEC later clarified that there is an affirmative duty to disclose when "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."<sup>126</sup> In these situations, companies should, and may even be obligated to, provide more than just a simple a discussion. Instead, companies should provide a detailed analysis of the pertinent information.<sup>127</sup> However, the SEC has cautioned that this obligation requires "quantitative information" only when it is "reasonably available and will provide material information for investors."<sup>128</sup>

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119. *See* Litwin v. Blackstone Grp., L.P., 634 F.3d 706, 717 n.10 (2d Cir. 2011) (citing Rombach v. Chang, 355 F.3d 164, 178 n.11 (2d Cir. 2004)).

120. *See* 15 U.S.C. §§ 77k(a), 77l(a)(2).

121. *See id.*

122. Panther Partners Inc. v. Ikanos Commc'ns, Inc., 681 F.3d 114, 120 (2d Cir. 2012) (noting that these sections "impose[] strict liability on issuers and signatories, and negligence liability on underwriters").

123. *Id.*

124. 17 C.F.R. § 229.303(a)(3)(ii) (2016).

125. *Id.* § 229.303(a), Instruction 3.

126. 1989 SEC Release, *supra* note 6, at 22,429.

127. *See* Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 68 Fed. Reg. 75,056, 75,056 (Dec. 29, 2003) [hereinafter 2003 SEC Release].

128. Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 105 (2d Cir. 2015) (quoting 2003 SEC Release, *supra* note 127, at 75,065).

The SEC also clarified that the test for materiality under Item 303 requires a two-step process.<sup>129</sup> First, if management decides that the “known trend, demand, commitment, event or uncertainty”<sup>130</sup> is not “reasonably likely to occur,” then they need not disclose.<sup>131</sup> The key phrase to this part of the analysis is “reasonably likely to occur.” While no specific percentage is given, it is a less demanding standard than “more likely than not.”<sup>132</sup> Thus, this part of the test sets a low bar for disclosure; if a trend is reasonably likely to occur, it must be disclosed.

The second part of the test provides a contingency plan for when management is unable to make the determination that the trend is not reasonably likely to occur.<sup>133</sup> If management cannot make such determination, it must assume that the trend will occur and objectively evaluate its consequences.<sup>134</sup> Management must disclose this trend unless it “determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.”<sup>135</sup>

Despite this guidance from the SEC, the requirements under this section are flexible and complicated, leaving the company with a difficult task.<sup>136</sup> Item 303 disclosures are intended to provide investors with a unique view of the registrant.<sup>137</sup> By providing investors with this perspective, it provides context that will assist in understanding where a company is headed and whether it would be a wise investment.<sup>138</sup> The SEC long has viewed a narrative explaining the disclosed financial statements as crucial to investor analysis of how indicative past performance is of the future success of the company.<sup>139</sup>

To ensure compliance, however, it is important to implement effective enforcement mechanisms.<sup>140</sup> Although Item 303 does not explicitly provide for a private cause of action, the SEC has other means by which to compel compliance.<sup>141</sup> For example, the SEC has the ability to enter cease

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129. See 1989 SEC Letter, *supra* note 6.

130. For the remainder of this Note, these terms will collectively be referred to as “trend.”

131. See 1989 SEC Letter, *supra* note 6, at 22,430.

132. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6302 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205) (“To be ‘reasonably likely’ a material violation must be more than a mere possibility, but it need not be ‘more likely than not.’”).

133. See 1989 SEC Letter, *supra* note 6, at 22,430.

134. See *id.*

135. *Id.*

136. Mark S. Croft, *MD&A: The Tightrope of Disclosure*, 45 S.C. L. REV. 477, 478 (1994).

137. See 1989 SEC Release, *supra* note 6, at 22,436 (“[T]he general purpose of the MD&A requirements [is] to give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant’s financial condition and results of operations, with particular emphasis on the registrant’s prospects for the future.”).

138. See *id.*

139. See 1987 SEC Release, *supra* note 6, at 13,717.

140. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1034 (2000) (noting the importance of enforcing prohibitions against fraud).

141. See Croft, *supra* note 136, at 498–99.

and desist orders against a company that files a deficient MD&A.<sup>142</sup> Not only is this a way to enforce rules promulgated by the SEC, but it also provides another avenue for the SEC to provide guidance to companies on how to adhere to its regulations.<sup>143</sup>

For example, the SEC's *In re Caterpillar*<sup>144</sup> called upon the company to cease and desist from any action that resulted in a violation of the MD&A requirements.<sup>145</sup> In addition, the company was required to "implement and maintain procedures designed to ensure compliance with Item 303."<sup>146</sup> The SEC found the company's procedures to be inadequate, despite the fact that the MD&A in dispute was reviewed by several of the company's officers, including the treasurer, legal counsel, and accounting department.<sup>147</sup>

## II. THE CIRCUIT SPLIT: WHETHER VIOLATIONS OF ITEM 303 MAY SERVE AS A BASIS FOR LIABILITY UNDER RULE 10b-5

Part II of this Note examines the question of whether failure to comply with a disclosure requirement created by Item 303 can provide a basis for liability under Rule 10b-5. Part II.A discusses three cases, a Third Circuit decision and two Second Circuit decisions, analyzed by the Ninth Circuit and the Second Circuit in reaching their conflicting conclusions. Part II.B thoroughly examines a subsequent Ninth Circuit case, where the court considered whether violating Item 303 may serve as a basis for liability under Rule 10b-5. Then, Part II.C discusses the Second Circuit's analysis of the same question, including its critique of the Ninth Circuit's approach. Finally, Part II.D briefly summarizes the competing arguments articulated in this circuit split.

### A. *Paving the Road for the Rulings: Qualification and Analogy*

This section discusses the three main cases examined by both the Ninth Circuit and the Second Circuit in reaching their conflicting conclusions.

#### 1. *Oran v. Stafford*: Leaving the Door Ajar

In *Oran v. Stafford*,<sup>148</sup> the plaintiff stockholders alleged that American Home Products Corporation (AHP) "made material misrepresentations and omissions" concerning the safety of the prescription drugs that they

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142. See, e.g., *Caterpillar, Inc.*, Exchange Act Release No. 34-30532, 50 S.E.C. 903 (Mar. 31, 1992). This was the first time the SEC used its new powers to require companies to cease and desist from actions that constituted violations of certain regulations. See Croft, *supra* note 136, at 504.

143. See *Caterpillar*, 50 S.E.C. at 912 (noting specific reasons why the MD&A in question was deficient).

144. Exchange Act Release No. 34-30532, 50 S.E.C. 903 (Mar. 31, 1992).

145. See *id.* at 913.

146. *Id.*

147. See *id.* at 907.

148. 226 F.3d 275 (3rd Cir. 2000). Then-Judge Samuel A. Alito authored the majority opinion for the Third Circuit.



manufactured.<sup>149</sup> Consequently, the plaintiffs claimed that they experienced a significant financial loss when AHP's stock price dropped following the disclosure of this previously withheld information.<sup>150</sup>

After the district court dismissed the complaint, the plaintiffs appealed and argued, among other things, that AHP violated Item 303, and such violation served as a basis for liability under section 10(b) and Rule 10b-5.<sup>151</sup> The Third Circuit held that in order for the plaintiffs to succeed, they had to establish that Item 303 “creates an independent private right of action, or that the regulation imposes an affirmative duty of disclosure on AHP that, if violated, would constitute a material omission under Rule 10b-5.”<sup>152</sup>

After explicitly holding that Item 303 does not create an independent private cause of action, the Third Circuit analyzed whether Item 303 creates an affirmative duty to disclose material information.<sup>153</sup> In evaluating this argument, it examined whether Item 303 disclosure is regulated in a manner consistent with the standards imposed by the Supreme Court for private fraud actions.<sup>154</sup> Finding that the materiality standards for Rule 10b-5 “differ significantly” from those for Item 303,<sup>155</sup> the Third Circuit stated: “[D]emonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5. Such a duty to disclose must be separately shown.”<sup>156</sup>

Thus, *Oran* held “that a violation of [Item 303’s] reporting requirements does not automatically give rise to a material omission under Rule 10b-5. Because plaintiffs have failed to plead any actionable misrepresentation or omission under that Rule, [Item 303] cannot provide a basis for liability.”<sup>157</sup> Both the Ninth Circuit and Second Circuit would subsequently rely on this case, and particularly this phrase, to justify their conflicting conclusions.<sup>158</sup>

## 2. *Litwin v. Blackstone Group, L.P.*

In *Litwin v. Blackstone Group, L.P.*,<sup>159</sup> the Second Circuit analyzed whether violations of Item 303 may serve as a basis for liability under

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149. *Id.* at 279. The plaintiffs claimed that AHP failed to disclose that there were several studies that linked these drugs, Pondimin and Redux, to heart-valve damage. *Id.*

150. *Id.*

151. *See id.* at 281.

152. *Id.* at 287.

153. *See id.* at 287–88.

154. The Third Circuit compared the SEC’s interpretation of the disclosure obligations created by Item 303 with the general securities fraud materiality standard established by the Supreme Court in *Basic*. *See id.*

155. According to the SEC, “the probability/magnitude test for materiality approved by the Supreme Court in *Basic* . . . is inapposite to Item 303 disclosure.” *See* 1989 SEC Release, *supra* note 6, at 22,430 n.27.

156. *Oran*, 226 F.3d at 288 (quoting *Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 608 (N.D. Cal. 1991)).

157. *Id.*

158. *See infra* Part II.B–C.

159. 634 F.3d 706 (2d Cir. 2011).

sections 11 and 12(a)(2). Although the Ninth Circuit ultimately agreed with the Second Circuit on the outcome of *Litwin*, the courts disagreed over whether the analysis therein was applicable to understanding the connection between Item 303 and Rule 10b-5.

In this case, the plaintiffs<sup>160</sup> alleged that the defendants<sup>161</sup> violated sections 11 and 12(a)(2) of the 1933 Act by both omitting and affirmatively misstating material information in the company's initial public offering registration statement and prospectus.<sup>162</sup> Specifically, plaintiffs alleged that the defendants were aware of, and failed to disclose, problems relating to certain portfolio companies and investments that the company should have reasonably expected to have material effects on its future revenues.<sup>163</sup> Plaintiffs contended that because the defendants were obligated to disclose this information under Item 303, failure to do so provided the basis for liability.<sup>164</sup>

The Second Circuit noted that, to promote compliance with disclosure obligations, section 11 places a low burden on the plaintiff.<sup>165</sup> The focus then shifted to the legal standard for materiality, which is stated to be the same as that for Rule 10b-5 claims.<sup>166</sup> After citing the standard for materiality laid out in *Basic*,<sup>167</sup> the court reaffirmed its rejection of a formulaic approach to materiality analysis.<sup>168</sup> It also noted that this analysis is a fact-based inquiry that must include assessment of both qualitative and quantitative factors.<sup>169</sup>

In analyzing the materiality of the defendants' alleged omissions and misstatements, the Second Circuit focused on several factors. First, although the fact that information is publicly available is relevant, it is not dispositive.<sup>170</sup> While certain events pertaining to the defendants' company were publicly known, the potential impact of those events on the future of the company was not.<sup>171</sup> Second, the court rejected the defendants' use of a balancing test to avoid disclosure of material events that have negative

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160. The plaintiffs in this class action were all individuals who purchased shares of the defendant corporation at the time of its initial public offering. *See id.* at 708.

161. The defendants were Blackstone Group, L.P. and several of its executives. *Id.* at 708–09.

162. *Id.* at 708.

163. *Id.* at 710.

164. *Id.* at 716.

165. *Id.* (quoting *Herman & Mac-Lean v. Huddleston*, 459 U.S. 375, 381–82 (1983)).

166. *Id.* at 717 n.10.

167. *See Basic v. Levinson*, 485 U.S. 224, 231–32 (1988).

168. *Litwin*, 634 F.3d at 717.

169. *Id.* (citing SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999)). With respect to quantitative factors, the SEC suggested using a 5 percent deviation as a benchmark. Any disclosure that deviated from the actual value by less than 5 percent most likely would not be material. However, this may not be the case if the disclosure concerned was qualitatively significant. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. at 45,152.

170. *Litwin*, 634 F.3d at 718.

171. *Id.* at 718–19.

effects.<sup>172</sup> With regard to the qualitative analysis, the Second Circuit considered whether the misstatement or omission was related to a significant part of the company's business.<sup>173</sup>

Third, the Second Circuit addressed the defendants' concern that a broad interpretation of materiality would result in investors being buried with information, sacrificing quality for quantity.<sup>174</sup> Conceding that the SEC prohibits this influx of information, the court pointed to certain protections that quelled this concern.<sup>175</sup> Specifically, for omissions to serve as a basis for liability under sections 11 and 12(a)(2), the omitted information must be material and the company must have a duty to disclose.<sup>176</sup> Thus, the court held that the combination of these requirements provides sufficient protection from the threat of overdisclosure.

### 3. *Panther Partners Inc. v. Ikanos Communications, Inc.*

In *Panther Partners Inc. v. Ikanos Communications, Inc.*,<sup>177</sup> the Second Circuit again analyzed whether violations of Item 303 may serve as a basis for liability under sections 11 and 12(a)(2).<sup>178</sup> Specifically, the plaintiffs alleged that the defendant<sup>179</sup> failed to disclose a known defect in a major product in both its registration statement and the prospectus for its secondary offering.<sup>180</sup> Despite knowing the large scale of the defect, the defendant chose not to disclose particulars, but rather it issued a generic warning about the risks associated with selling complex products.<sup>181</sup> Thus, the plaintiffs alleged that the defendant violated Item 303 by failing to disclose this "known . . . uncertaint[y]."<sup>182</sup>

In its analysis, the Second Circuit noted that omissions may serve as a basis for liability under sections 11 and 12(a)(2) if a company has an affirmative legal obligation to disclose.<sup>183</sup> It then explicitly stated that the duty to disclose under Item 303 constituted such an obligation.<sup>184</sup> The Second Circuit also explained that analysis of Item 303 violations was

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172. *Id.* at 719. The defendants tried to claim that the information in dispute was not material because the loss was offset by gains in other parts of the company. The SEC also rejected this aggregation approach, concluding that each misstatement or omission should be considered independently. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. at 45,153.

173. *Litwin*, 634 F.3d at 720 (noting that the importance of the business segment being discussed is directly correlated to the likelihood that such disclosure is material).

174. *Id.* at 722.

175. *Id.*

176. *Id.* at 722–23.

177. 681 F.3d 114 (2d Cir. 2012).

178. *Id.* at 116. Although the plaintiffs also alleged violations of section 15 of the 1933 Act, this Note does not discuss those allegations.

179. The defendant company produced semiconductors used by original equipment manufacturers in the communications industry. *Id.*

180. *Id.* at 116–17. The plaintiffs alleged that the defendant became aware of this defect after receiving complaints from two of its largest customers. *Id.* at 116.

181. *Id.* at 117. Three months after the secondary offering, the defendant issued a recall of this defective product, which resulted in a \$2.2 million net loss. *Id.*

182. *Id.* (quoting 17 C.F.R. § 229.303(a)(3)(ii) (2016)).

183. *Id.* at 120.

184. *Id.*

similar to a materiality analysis in that neither relies on “restrictive mechanical or quantitative inquiries.”<sup>185</sup>

The Second Circuit relied on two critical factual allegations to vacate the district court’s denial of leave to amend. First, the defective product was sold to customers representing 72 percent of the defendant’s revenues.<sup>186</sup> Second, the company would be unable to easily ascertain exactly which products contained the defects.<sup>187</sup> Thus, the Second Circuit concluded that even though the precise magnitude of the harm was not known at the time the offering documents were released, it is plausible that the defendants were aware of an “uncertainty” that was “reasonably expected” to have a negative material impact on the company.<sup>188</sup>

### B. The Ninth Circuit: Closing the Door to Liability

In the Ninth Circuit’s *In re NVIDIA Corp. Securities Litigation*,<sup>189</sup> the court held that violating Item 303’s duty to disclose cannot provide a basis for liability under section 10(b) and Rule 10b-5.<sup>190</sup> In reaching this conclusion, the Ninth Circuit relied on both case law and SEC statements.<sup>191</sup>

Plaintiffs brought this case after the share price of NVIDIA Corporation<sup>192</sup> dropped 31 percent, decreasing its market capitalization by \$3 billion.<sup>193</sup> This loss occurred after NVIDIA filed an 8-K in July 2008, disclosing that the company would need to take “a \$150 to \$200 million charge to cover warranty, repair, return, replacement, and other costs,” resulting from defects in certain MCP<sup>194</sup> and GPU<sup>195</sup> products.<sup>196</sup>

According to the plaintiffs,<sup>197</sup> however, NVIDIA knew about the defects in its products, and the potential for liability, several months before this disclosure.<sup>198</sup> Plaintiffs further alleged that this information was material to investors and should have been disclosed.<sup>199</sup> Because NVIDIA failed to do so, other statements contained in these filings were misleading in violation

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185. *Id.* at 122.

186. *See id.* at 121.

187. *Id.*

188. *See id.*

189. 768 F.3d 1046 (9th Cir. 2014).

190. *See id.* at 1056.

191. *See id.* at 1054–56.

192. NVIDIA, a publicly traded company, produced semiconductors. *Id.* at 1048.

193. *See id.* at 1051.

194. MCPs are media and communications processors, which combine the functions of various devices, such as GPUs and audio signal processors. *See id.* at 1048.

195. GPUs are graphics processing units, which process the data required for rendering images on a computer. *See id.*

196. *Id.* at 1050.

197. The plaintiffs in this case consisted of a class of stockholders who purchased stock in NVIDIA during the class period: November 8, 2007 through July 2, 2008. *Id.* at 1051.

198. *See id.* at 1048. According to the complaint, NVIDIA began experiencing problems in September 2006. *See id.* at 1049. At that time, NVIDIA began making changes to these products and working with some of its customers to determine the cause of the defects. *See id.* at 1049–50.

199. *Id.* at 1051.

of section 10(b) and Rule 10b-5.<sup>200</sup> Specifically, the plaintiffs contended that because Item 303 creates a duty to disclose certain material information, failure to do so violates section 10(b) and Rule 10b-5.<sup>201</sup>

The court, noting that this was a matter of first impression in the Ninth Circuit, held that “Item 303’s disclosure duty is [not] actionable under [s]ection 10(b) and Rule 10b-5.”<sup>202</sup> In reaching this conclusion, the Ninth Circuit considered its own precedent<sup>203</sup> and the Third Circuit’s decision in *Oran*.<sup>204</sup> Focusing on the fact that the materiality standards for Rule 10b-5 “differ significantly” from those for Item 303, the Ninth Circuit concluded that this difference precluded Item 303 violations from serving as a basis for liability under Rule 10b-5.<sup>205</sup>

In addition, the Ninth Circuit rejected the comparison of Rule 10b-5 to sections 11 and 12(a)(2) of the 1933 Act.<sup>206</sup> It noted that unlike Rule 10b-5, liability under sections 11 and 12(a)(2) arises from a failure to comply with an affirmative duty to disclose.<sup>207</sup> Further, plaintiffs are not required to prove scienter in section 11 or section 12(a)(2) claims.<sup>208</sup> Thus, the Ninth Circuit found *NVIDIA* distinguishable from *Litwin* and *Panther Partners*.<sup>209</sup>

Finally, the Ninth Circuit rejected the plaintiffs’ argument based on *Simon v. American Power Conversion Corp.*<sup>210</sup> In *Simon*, the District Court of Rhode Island noted that Item 303 does create a disclosure obligation and that the defendant’s failure to disclose created a basis for liability.<sup>211</sup> The Ninth Circuit, however, pointed out that the District Court of Rhode Island later clarified *Simon* and held that a violation of Item 303, without more, does not establish that defendants violated Rule 10b-5.<sup>212</sup>

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200. *Id.* at 1048, 1051. The plaintiffs pointed to a number of filings to illustrate this claim, including an 8-K filed on February 13, 2008, which asserted: “Fiscal 2008 was another outstanding and record year for us. Strong demand for GPUs in all market segments drove our growth.” *Id.* at 1050.

201. *Id.* at 1054.

202. *Id.*

203. *See id.* (citing *In re VeriFone Sec. Litig.*, 11 F.3d 865, 870 (9th Cir. 1993)) (noting that because forecasts are addressed in a separate SEC regulation, such statements need not be disclosed under Item 303 and thus do not serve as a basis for liability under Rule 10b-5); *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1053 (9th Cir. 1993) (distinguishing between “known trends or uncertainties,” which must be disclosed under Item 303, and forecasts, which need not be disclosed under Item 303); *In re Convergent Techs. Sec. Litig.*, 948 F.2d 507, 516 (9th Cir. 1991) (noting that forecasts need not be disclosed under Item 303).

204. *See NVIDIA*, 768 F.3d at 1054–55; *see also supra* Part II.A.1.

205. *See NVIDIA*, 768 F.3d at 1055.

206. *See id.*

207. *See id.*

208. *See id.* at 1056.

209. *See id.* at 1055–56. For a detailed discussion of these two cases, *see supra* Part II.A.2–3.

210. 945 F. Supp. 416 (D.R.I. 1996); *see NVIDIA*, 768 F.3d at 1056.

211. *See Simon*, 945 F. Supp. at 431.

212. *See NVIDIA*, 768 F.3d at 1056 (citing *Kafenbaum v. GTECH Holdings Corp.*, 217 F. Supp. 2d 238, 250 (D.R.I. 2002)).

After considering these cases, the Ninth Circuit concluded that Item 303 does not establish a duty to disclose that can create liability under section 10(b) and Rule 10b-5.<sup>213</sup> Creating liability under Rule 10b-5 requires that plaintiffs establish a separate duty to disclose.<sup>214</sup> The Ninth Circuit also concluded that the plaintiffs failed to plead a strong inference of scienter and affirmed the district court's dismissal of the amended complaint.<sup>215</sup>

*C. The Second Circuit: Rejecting NVIDIA  
and Opening the Door to Liability*

In *Stratte-McClure v. Morgan Stanley*,<sup>216</sup> the Second Circuit held that violating the disclosure requirements established by Item 303 may serve as a basis for liability under section 10(b) and Rule 10(b)(5).<sup>217</sup> It qualified this holding, however, by noting that such a violation can create liability only "if the allegedly omitted information satisfies *Basic's* test for materiality," and the plaintiff satisfies all of the other requirements necessary to sustain a 10b-5 action.<sup>218</sup>

In *Stratte-McClure*, the plaintiffs<sup>219</sup> claimed that the defendants<sup>220</sup> "made material misstatements and omissions between June 20, 2007 and November 19, 2007 (the class period) in an effort to conceal Morgan Stanley's exposure to and losses from the subprime mortgage market."<sup>221</sup> Consequently, the plaintiffs alleged that they "suffered substantial financial loss" when Morgan Stanley's stock price dropped after the truth was publicly disclosed.<sup>222</sup>

This case centered on a "massive proprietary trade" executed by the defendants in December 2006.<sup>223</sup> In this trade, the defendants were essentially "betting that defaults in the subprime mortgage markets would be significant enough to impair the value of the higher-risk collateralized debt obligations (CDO) tranches referenced by the Short Position,<sup>[224]</sup> but not significant enough to impair the value of the lower-risk CDOs tranches referenced by the Long Position."<sup>225</sup>

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213. *See id.*

214. *See id.* at 1055.

215. *See id.* at 1048, 1062.

216. 776 F.3d 94 (2d Cir. 2015).

217. *See id.*

218. *Id.* at 103.

219. The plaintiffs were a class of investors, led by State-Boston Retirement System and Fjarde AP-Fonden. *Id.* at 96.

220. The defendants were Morgan Stanley and six former and current officers. *Id.*

221. *Id.*

222. *Id.*

223. *Id.* at 97.

224. In the "Short Position," the credit default swaps (CDS), purchased by the defendant on CDOs backed by mezzanine tranches of subprime residential mortgage-backed securities (RMBS), functioned like insurance policies. In return for the payment of annual premiums, the defendant received payments if these RMBSs defaulted or declined in value as a result of a declining housing market. *See id.*

225. *Id.* In the "Long Position," the defendant sold CDSs that were similar to the ones purchased in the Short Position, but these CDSs were referenced by higher-rated, lower-risk CDOs. Since the defendant was the seller in the Long Position, it received premiums in

Although the defendants accurately predicted that the subprime mortgage markets would decline, they underestimated the magnitude, which resulted in a loss of billions of dollars.<sup>226</sup> The plaintiffs contended that the defendants made many material misstatements and omissions to conceal their “exposure to and losses from” this transaction during the class period.<sup>227</sup>

Specifically, the plaintiffs alleged that Morgan Stanley made material omissions in its 10-Q filings by failing to disclose the losses sustained on the “Long Position” in 2007 and that it was likely to suffer additional substantial losses in the future.<sup>228</sup> Consequently, the plaintiffs claimed, the defendants violated the Item 303 obligation to disclose “known trends, or uncertainties that have had, or might reasonably be expected to have, a[n] . . . unfavorable material effect.”<sup>229</sup>

Noting that this was a matter of first impression in the Second Circuit, the court concluded that an Item 303 violation may be actionable under section 10(b) and Rule 10b-5, but only if the violation satisfies the materiality standards established by *Basic* and all of the other requirements necessary to sustain such action.<sup>230</sup> In reaching this conclusion, it relied on precedent, other sections of the 1933 Act, and scholarly commentary.

The Second Circuit noted that it consistently had held that an omission is actionable only when there is a duty to disclose the omitted information.<sup>231</sup> This duty to disclose may be created by insider trading violations, a statute or regulation, or a statement that would be “inaccurate, incomplete, or misleading” without additional disclosure.<sup>232</sup> Agreeing with the plaintiffs, the court found that Item 303 imposes an obligation to disclose “any known trends or uncertainties . . . that the registrant reasonably expects will have a material . . . unfavorable impact on . . . revenues or income from continuing operations.”<sup>233</sup>

After concluding that Item 303 creates an affirmative duty to disclose, the Second Circuit noted that courts have historically recognized that Rule 10b-5 violations can be “derive[d] from statutes or regulations that obligate a party to speak.”<sup>234</sup> Because Item 303 requires these disclosures, an investor could reasonably interpret silence as an implication that there are

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exchange for the promise that it would distribute payments if these higher-rated CDOs defaulted or declined in value. *See id.*

226. *See id.*

227. *Id.* at 98. There were two categories of misrepresentations and omissions: those regarding the defendant’s exposure to credit risk arising from the Long Position (“the exposure claim”) and those regarding the losses from the Long Position (“the valuation claim”). *Id.*

228. *See id.*

229. *Id.*

230. *See id.* at 107–08.

231. *See id.* at 101. These holdings were the result of the Supreme Court’s conclusion that if there is no duty to disclose, silence is not misleading under Rule 10b-5. *See id.* at 100–01 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988)).

232. *Id.* at 101 (quoting *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1st Cir. 1990)).

233. *Id.* (quoting 17 C.F.R. § 229.303(a)(3)(ii) (2016)).

234. *Id.* at 102.

no “known trends or uncertainties . . . that the registrant reasonably expects will have a material . . . unfavorable impact on . . . revenues or income from continuing operations.”<sup>235</sup> Thus, if such trends or uncertainties do exist, silence may be misleading to investors.<sup>236</sup>

Although the Second Circuit acknowledged that Item 303 and Rule 10b-5 have different materiality standards, it did not find these differences significant enough to automatically preclude liability.<sup>237</sup> Instead, it held that, although Item 303 violations establish that a defendant has a duty to disclose, a plaintiff must also establish that the omission was material under *Basic* to be successful.<sup>238</sup>

The Second Circuit also compared *Stratte-McClure* to *Litwin* and *Panther Partners*, where it held Item 303 violations to be actionable under section 11 and section 12(a)(2).<sup>239</sup> Noting the similarity in the language of section 12(a)(2) and Rule 10b-5,<sup>240</sup> it held that in both contexts, omitting information required by Item 303 may mislead investors.<sup>241</sup> Thus, because Item 303 may create a duty to disclose under section 12(a)(2), the same is true for claims brought under Rule 10b-5.<sup>242</sup>

Although the Second Circuit found that the plaintiffs successfully had alleged that the defendant violated the duty to disclose created by Item 303,<sup>243</sup> it affirmed the dismissal of the claim because the plaintiffs failed to adequately plead scienter.<sup>244</sup>

The Second Circuit also explicitly noted its disagreement with the Ninth Circuit.<sup>245</sup> Specifically, the Second Circuit found that the Ninth Circuit had misinterpreted *Oran* and refuted the notion that *Oran* conclusively established that violations of Item 303 are never actionable under Rule 10b-5.<sup>246</sup> Instead, the Second Circuit found that *Oran* actually opened the door to the possibility that such liability could be created in certain situations.<sup>247</sup> Noting that, at the very least, *Oran* is consistent with the holding that Item 303 violations can establish liability under Rule 10b-5 if

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235. 17 C.F.R. § 229.303(a)(3)(ii).

236. See *Stratte-McClure*, 776 F.3d at 102.

237. See *id.* at 103.

238. See *id.*

239. See generally *Panther Partners Inc. v. Ikanos Commc'ns, Inc.*, 681 F.3d 114 (2d Cir. 2012); *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706 (2d Cir. 2011). For a discussion of these cases see *supra* Part II.A.2–3.

240. See *Stratte-McClure*, 776 F.3d at 102 (quoting 17 C.F.R. § 240.10b-5) (“Like [s]ection 12(a)(2), Rule 10b-5 requires disclosure of ‘material fact[s] necessary in order to make . . . statements made . . . not misleading . . .’”).

241. See *id.* at 104.

242. See *id.*

243. The court rejected the defendant’s argument that it satisfied its Item 303 obligations, finding that its “disclosures about market trends were generic, spread out over several different filings, and often unconnected to the company’s financial position.” *Id.* at 105.

244. See *id.* at 106.

245. See *id.* at 103.

246. See *id.*

247. See *id.* (quoting *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000)).



the other elements of Rule 10b-5 have been established and the omission meets the *Basic* standard for materiality.<sup>248</sup>

In addition, the Second Circuit found that in *NVIDIA*, the Ninth Circuit “misconstrue[d] the relationship between Rule 10b-5 and [s]ection 12(a)(2).”<sup>249</sup> Although the Ninth Circuit previously followed the decision in *Panther Partners*, it failed to note that both Rule 10b-5 and section 12(a)(2) have “textually identical” prohibitions on omissions.<sup>250</sup> Thus, both *Panther Partners* and *Litwin* are relevant to this issue and “provide firm footing” for the Second Circuit’s conclusion.<sup>251</sup>

#### D. Summary of the Circuit Split

As noted in *Stratte-McClure*, the Second Circuit and the Ninth Circuit are “at odds” regarding whether a violation of Item 303 is actionable under Rule 10b-5.<sup>252</sup> While both courts used *Oran* to support their conflicting conclusions, they disagreed over the repercussions of the Third Circuit’s determination that, due to the differing materiality standards of Item 303 and Rule 10b-5, a violation of Item 303 “does not automatically give rise to a material omission under Rule 10b-5.”<sup>253</sup> The Ninth Circuit found that this statement supported an absolute bar to liability, while the Second Circuit held that this language allowed for the possibility of liability in certain situations.<sup>254</sup>

In addition, the Second Circuit and the Ninth Circuit disagreed over whether it was appropriate to analogize to cases brought under sections 11 and 12(a)(2). In *Litwin* and *Panther Partners*, the Second Circuit “established that Item 303 creates a duty to disclose for the purposes of liability under [s]ection 12(a)(2).”<sup>255</sup> Relying on the fact that both section 12(a)(2) and Rule 10b-5 prohibit omissions of material facts necessary to make other statements not misleading, the Second Circuit found that Item 303 also could establish a duty to disclose for purposes of Rule 10b-5.<sup>256</sup> The Ninth Circuit, however, despite adopting the conclusions of *Litwin* and *Panther Partners*,<sup>257</sup> found those decisions to be “irrelevant to its analysis of Rule 10b-5.”<sup>258</sup>

Finally, it is worth noting that, despite these different conclusions, both cases were dismissed, at least in part, because the plaintiffs failed to adequately plead scienter.<sup>259</sup>

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248. *See id.* at 103–04.

249. *Id.* at 104.

250. *See id.*

251. *See id.*

252. *Id.* at 103.

253. *Id.*

254. *See id.* at 103–04.

255. *Id.* at 104.

256. *See id.*

257. *See Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998).

258. *Stratte-McClure*, 776 F.3d at 104.

259. *See id.* at 106; *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1065 (9th Cir. 2014).

### III. THE SUPREME COURT SHOULD ADOPT *STRATTE-MCCLURE*

Part III of this Note argues that the Supreme Court should examine this issue and adopt the Second Circuit's conclusion that violations of Item 303 may create liability under Rule 10b-5, but only in instances where the other elements of Rule 10b-5 have been satisfied and the omission or misstatement meets the *Basic* standard for materiality. Part III.A discusses the relationship between the materiality standards for Item 303 and Rule 10b-5. Part III.B presents and resolves several hypotheticals addressing the different potential outcomes of Item 303 and Rule 10b-5 analyses. Part III.C discusses three cases underlying the Second Circuit's analysis. Next, Part III.D explains how the remedies for Item 303 violations and Rule 10b-5 claims support this conclusion. Finally, Part III.E describes how the Second Circuit's conclusion will impact various participants in the securities markets.

#### A. *Materiality: The Connection Between Separate Standards and Related Roles*

In rejecting the notion that Item 303 could provide a basis for liability under 10b-5, the Ninth Circuit focused on the differing materiality requirements.<sup>260</sup> While the SEC did explicitly state that the *Basic* materiality test was "inapposite to Item 303 disclosure,"<sup>261</sup> that assertion does not necessarily mean that there is no overlap between the two standards.<sup>262</sup> In certain instances, as illustrated by the scenarios below, information may satisfy both Item 303's and Rule 10b-5's materiality standards.<sup>263</sup>

Looking at both parts of the Item 303 materiality test promulgated by the SEC,<sup>264</sup> it becomes evident that probability is the driving factor.<sup>265</sup> Even though the second part of this test calls upon management to assume that a trend will happen, the exception, which eliminates the obligation to disclose, also is based on a probability analysis.<sup>266</sup> Regardless of the magnitude of the potential material effect on the registrant's finances or operations, if that effect is not reasonably likely to occur, it need not be disclosed under Item 303.<sup>267</sup> The Rule 10b-5 materiality standard, however, incorporates both probability and magnitude.<sup>268</sup> Under this test, even an event that is not reasonably likely to occur might need to be disclosed if its potential impact on the company is extreme.

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260. *NVIDIA*, 768 F.3d at 1055.

261. 1989 SEC Release, *supra* note 6, at 22,430 n.27.

262. *See Stratte-McClure*, 776 F.3d at 103.

263. *See infra* Part III.B.

264. *See supra* Part I.C.3.

265. *See generally* 1989 SEC Letter, *supra* note 6.

266. *See id.*

267. *See id.*

268. *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

While this discrepancy supports the conclusion that an Item 303 violation does not inevitably provide a basis for liability under Rule 10b-5, it does not justify a complete bar against such liability.<sup>269</sup> A proper analysis of the relationship between Item 303 and Rule 10b-5 should include two steps. First, courts should analyze whether Item 303 creates a duty to disclose the information in question.<sup>270</sup> Then, courts should conduct a separate analysis to see if the information satisfies the materiality standard set forth by the Supreme Court in *Basic*.<sup>271</sup> In situations where the information has a high probability of occurring, failure to disclose will violate Item 303 and simultaneously satisfy Rule 10b-5's materiality requirement.

*B. Hypotheticals: Relationship Between  
Item 303 and Rule 10b-5*

On closer consideration, it becomes evident that there are four distinct possibilities when considering the relationship between Item 303 and Rule 10b-5: Item 303 violation only; Rule 10b-5 violation only; Item 303 and Rule 10b-5 violation; and no violation.<sup>272</sup> This section will use hypotheticals to discuss the first three possibilities. In each of these hypotheticals, a company is deciding whether it should disclose the occurrence of a particular event, considering whether an omission of this information would violate Item 303, Rule 10b-5, or both.

In scenario one, assume that a new regulation is proposed that, if adopted, will require the company to completely redesign its product. Assuming this event is not reasonably likely to occur, the two tests will produce conflicting results. Under Item 303, no disclosure is necessary because this event is not reasonably likely to occur.<sup>273</sup> Under Rule 10b-5, however, because the magnitude of the impact of the event is so great, disclosure is required, even if the event has a low probability of coming to fruition.<sup>274</sup>

In scenario two, assume that a new regulation is proposed that, if adopted, will compel the company to purchase additional safety equipment for its workers. Assume that the probability of this event occurring is 20 percent, but that the consequences will not be significant in magnitude. Under these circumstances, because the event is reasonably likely to occur, it must be disclosed under Item 303.<sup>275</sup> Rule 10b-5, however, will not require disclosure because of the combination of low probability and low magnitude.<sup>276</sup>

In scenario three, assume that a new regulation is proposed that, if adopted, will cause the company to recall the majority of the products it

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269. See *supra* Part II.A.1, II.C.

270. See *supra* Part II.A.2-3; see also Crawford & Galaro, *supra* note 10.

271. See *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 104 (2d Cir. 2015).

272. See *supra* Part I.C.

273. See *supra* Part I.C.

274. See *supra* Part I.C.

275. See *supra* Part I.C.

276. See *supra* Part I.C.

sold in the past year. Assume that adoption of this regulation is reasonably likely to occur. In this situation, a company would be required to disclose under both Item 303 and Rule 10b-5.<sup>277</sup> It is this scenario that demonstrates that, while not inevitable, a violation of Item 303 may serve as a basis for liability under 10b-5.<sup>278</sup>

In scenario three, however, it is important to recognize that two separate analyses are being conducted and that each violation plays a distinct role in the 10b-5 analysis. The Item 303 violation does not speak to the materiality requirement of a 10b-5 claim, but rather to the question of whether the registrant had a duty to disclose.<sup>279</sup> Plaintiffs also must establish that the omitted information, which was alleged to constitute the Item 303 violation, satisfies the materiality standard established under *Basic*.<sup>280</sup> To be successful, any plaintiff additionally must prove the remaining elements required for a 10b-5 claim.<sup>281</sup>

### C. Cases: *Oran*, *Panthers Partners*, and *Litwin*

Although both the Ninth Circuit and the Second Circuit relied on the same three cases when analyzing whether Item 303 violations are actionable under Rule 10b-5, they did so in different ways. This section will illustrate why the Second Circuit's analysis of each case should be accepted, supporting the conclusion that such violations are actionable.

First, the Second Circuit correctly concluded that *Oran* left open the possibility that a violation of Item 303 may produce liability under Rule 10b-5.<sup>282</sup> Although the *Oran* Court did comment on the diverging materiality standards of these two regulations, it did not foreclose the possibility that there may be instances when the two overlap.<sup>283</sup> Instead of bifurcating its analysis, the Ninth Circuit combined the question of whether there is a duty to disclose with the question of whether the information was material.<sup>284</sup>

Although this Note concludes that the Second Circuit's interpretation of *Oran* is more accurate, it is also important to consider whether *Oran* itself was decided correctly. After analyzing the relationship between the materiality standards of Item 303 and Rule 10b-5, it becomes clear that, although not inevitable, there are situations in which a company's omission may constitute a violation of Item 303 and simultaneously satisfy the materiality requirement of Rule 10b-5.<sup>285</sup> Thus, this Note concludes that

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277. See *supra* Part I.C.

278. See *supra* Parts I.C, II.C.

279. See *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 103 (2d Cir. 2015).

280. See *id.*

281. See *supra* Part I.C.1.

282. See *Stratte-McClure*, 776 F.3d at 103–04.

283. See *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000) (noting that Item 303 violations do not “inevitably” or “automatically” constitute a material omission under Rule 10b-5).

284. See *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1055–56 (9th Cir. 2014).

285. See *supra* Part III.B.

*Oran* accurately articulates the relationship between Item 303 and Rule 10b-5.

This Note also advocates for the Second Circuit's conclusion that *Litwin* and *Panther Partners* are relevant to this issue. Although sections 11 and 12(a)(2) impose a lower burden on plaintiffs than Rule 10b-5, the test for materiality is the same for all three causes of action.<sup>286</sup> Thus, the materiality standard applied to sections 11 and 12(a)(2) is distinct from materiality for purposes of Item 303.<sup>287</sup> Despite these diverging materiality standards, in *Panther Partners*, the Second Circuit explicitly found that Item 303 creates a duty to disclose that may serve as a basis for section 11 and 12(a)(2) claims.<sup>288</sup> This bifurcated analysis allows courts to give proper consideration to each materiality standard without unnecessarily closing the door to certain forms of liability.<sup>289</sup>

The fact that several elements of a Rule 10b-5 claim, including scienter, are not required to bring a successful claim under sections 11 and 12(a)(2) does not render claims brought under sections 11 and 12(a)(2) irrelevant to those brought under Rule 10b-5.<sup>290</sup> In all three claims, a material omission may serve as a basis for liability if the party had a legal obligation to disclose that information.<sup>291</sup> It is important to note, however, that this conclusion does not reduce the importance of the other elements required to bring a successful claim under Rule 10b-5.<sup>292</sup> As illustrated by *NVIDIA* and *Stratte-McClure*, courts may disagree over the impact of an Item 303 violation and yet agree that plaintiffs have failed to adequately plead a claim under Rule 10b-5.<sup>293</sup> Thus, this analogy is appropriate to the limited extent of illustrating the relationship between Item 303 violations and the materiality standard established by the Supreme Court in *Basic*.<sup>294</sup>

#### D. The Role of Remedies

Following the conclusion reached by the Ninth Circuit would limit enforcement of Item 303 violations.<sup>295</sup> Although *Stratte-McClure* does not go so far as to create a private right of action for Item 303 violations, by connecting them to Rule 10b-5 claims, it changes the spectrum of remedies

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286. See *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 717 n.10 (2d Cir. 2011).

287. See *Stratte-McClure*, 776 F.3d at 103–04.

288. See *Panther Partners Inc. v. Ikanos Commc'ns, Inc.*, 681 F.3d 114, 120 (2d Cir. 2012).

289. See *Stratte-McClure*, 776 F.3d at 104 (noting that Item 303 violations can mislead investors and thus violate Rule 10b-5).

290. See *id.* at 102.

291. See *id.* (“This Court and our sister circuits have long recognized that a duty to disclose under [s]ection 10(b) can derive from statutes or regulations that obligate a party to speak.”). The Second Circuit also noted that this decision is supported by an SEC cease-and-desist order, which held that omissions that violate Item 303 constituted violations of section 10(b) and Rule 10b-5. See *id.* at 102 n.5.

292. See *supra* Part I.C.1.

293. See *supra* Part II.D.

294. See *Stratte-McClure*, 776 F.3d at 104.

295. See, e.g., *Caterpillar, Inc.*, Exchange Act Release No. 34-30532, 50 S.E.C. 903 (Mar. 31, 1992).

available to those harmed by such violations.<sup>296</sup> Because one of the remedies awarded for successful Rule 10b-5 claims is damages, allowing violations of Item 303 to serve as a basis for Rule 10b-5 liability will provide a much greater incentive for companies to comply with Item 303 regulations.<sup>297</sup>

This is a desired result because of the intrinsic value Item 303 disclosure provides to investors.<sup>298</sup> The explanatory narrative of the required financial statements is particularly helpful for evaluating “the likelihood that past performance is indicative of future performance.”<sup>299</sup> Although the SEC has used its enforcement mechanisms to encourage compliance with Item 303 obligations, expanding liability to include the possibility of having to pay damages provides an even stronger incentive to comply.<sup>300</sup> While adopting the holding of *Stratte-McClure* will most likely increase the number of cases brought, the other elements of a Rule 10b-5 claim will help protect against an influx of unnecessary litigation.<sup>301</sup>

One counterargument, however, is that the creation of this liability may cause companies to respond by disclosing too much information.<sup>302</sup> The requirements of Item 303, however, provide some intrinsic safeguards to protect against this risk. First, because Item 303 requires issuers to disclose *negative* trends and uncertainties, companies will not seek to provide more information than necessary.<sup>303</sup> Further, Item 303 is limited in scope. For example, MD&A disclosure is limited to “known trends” or “uncertainties.”<sup>304</sup> It is unlikely that companies will expend resources to gather additional information simply to inundate the investor with such data.<sup>305</sup>

### E. The Broader Impact

From the inception of a regulatory scheme centered on mandatory disclosure, tension between the needs of the various participants in the securities markets has spurred continuous calls for reform.<sup>306</sup> While it will not resolve all of these disputes, concluding that Item 303 may serve as a basis for liability under Rule 10b-5 assists in creating a regulatory regime that fosters the production of useful information. This section discusses the

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296. See *supra* Part I.C.1.

297. See Dickey & Stern, *supra* note 8 (noting that the Second Circuit significantly “raised the bar” for disclosure obligations).

298. See generally 1989 SEC Release, *supra* note 6.

299. *Id.*

300. See *Caterpillar, Inc.*, 50 S.E.C. 903.

301. See Buerger, Ehrlich & Soloway, *supra* note 13.

302. See Easterbrook & Fischel, *supra* note 71, at 696 (noting that more information is not always better).

303. See *supra* Part I.C.3.

304. 17 C.F.R. § 229.303(a)(3)(ii) (2016).

305. See Easterbrook & Fischel, *supra* note 71, at 697 (noting that firms have an inherent disincentive to produce information whose costs cannot be imposed on third parties).

306. See *supra* Part I.A–B.

impact of such liability on companies, sophisticated investors, and unsophisticated investors.

Although such liability imposes a stronger burden on companies to provide sufficient disclosure under Item 303, this burden does not necessarily impose exorbitant costs. First, because Item 303 is meant to provide an insight into the manager's perspective of the company,<sup>307</sup> it is unlikely that such disclosure will require the company to expend additional resources on research. On the other hand, the company may be forced to incur costs such as time, particularly the time of its management. This cost, however, may simultaneously be a benefit to the company. Spending more time preparing the MD&A may result in management having a better understanding of the company and being better equipped to plan for its future. This proposition also refutes the argument that additional disclosure requirements will disadvantage smaller companies.<sup>308</sup>

In addition, concluding that Item 303 is actionable under Rule 10b-5 will alleviate a company's fear that other companies will be able to unfairly exploit disclosed information.<sup>309</sup> Because such disclosure is required of all companies, each company can disclose information without the fear of being unfairly disadvantaged.<sup>310</sup> Further, as explicitly noted by the Second Circuit, the SEC does not require companies to disclose "internal business strategies or to identify the particulars of its trading positions."<sup>311</sup>

This proposed resolution also provides benefits to both sophisticated and unsophisticated investors. More thorough Item 303 disclosures reduce expenses that sophisticated investors need to spend on gathering and verifying such information.<sup>312</sup> While these investors are less dependent on the MD&A to understand disclosed financial information, such disclosure still may assist them in understanding the trajectory of the company.<sup>313</sup>

Ensuring that companies comply with Item 303 is especially useful for unsophisticated investors, who may not be as equipped as sophisticated investors to discern the implications of the vast amount of financial data disclosed by companies. While unsophisticated investors benefit from prices that reflect publicly disclosed information, these prices do not always accurately describe the risks associated with particular investments.<sup>314</sup> Not only does the resolution presented in *Stratte-McClure* encourage companies to pay closer attention to Item 303 disclosures, but it also provides an avenue for relief for those investors who truly were harmed by misleading information.

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307. See generally 1989 SEC Release, *supra* note 6.

308. See Gulati, *supra* note 7, at 689–90 (noting that disseminating such information is more costly for smaller businesses than larger companies, putting smaller companies at a relative disadvantage).

309. See Langevoort, *supra* note 104, at 116.

310. See Easterbrook & Fischel, *supra* note 71, at 686.

311. *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 105 (2d Cir. 2015).

312. See Coffee, Jr., *supra* note 73, at 728.

313. See 1989 SEC Release, *supra* note 6, at 22,428.

314. See Coffee, Jr., *supra* note 73, at 750.

## CONCLUSION

Although the debate surrounding mandatory disclosure began at the inception of securities regulations, the circuit split concerning whether violations of Item 303 may serve as a basis for liability under Rule 10b-5 has only recently been brought to light. Soon after the Ninth Circuit concluded that Item 303 violations are not actionable under Rule 10b-5, the Second Circuit explicitly rejected that holding. Disagreeing with multiple aspects of the Ninth Circuit's analysis, the Second Circuit held that Item 303 violations can serve as a basis for liability under Rule 10b-5. Noting that this was a matter of first impression, the Second Circuit also qualified this conclusion so that such liability may only be found if plaintiffs satisfy all other requirements of a Rule 10b-5 claim, including the materiality requirements set forth in *Basic*.

Based on the foregoing analysis, this Note concludes that the Second Circuit's holding in *Stratte-McClure* should be accepted. The fact that materiality standards for Item 303 and Rule 10b-5 are different does not preclude information from simultaneously meeting both standards. In addition, the importance of Item 303, and the unique insight it provides into the status of a company, support a resolution that encourages accurate and sufficient Item 303 disclosure. Thus, the Supreme Court should resolve this dispute by holding that, in certain situations, violations of Item 303 may result in successful Rule 10b-5 claims.