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Joshua D. Radbill

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“10(b) or Not 10(b) – That is the Question:  
A Quest For Securities Fraud Liability for Item 303 Omissions”  
By: Joshua D. Radbill  
JD Candidate, Seton Hall University School of Law (’17)

### Introduction

The Securities Exchange Acts of 1933<sup>1</sup> and 1934<sup>2</sup> were enacted by Congress in response to the 1929 stock market crash.<sup>3</sup> The purpose of the 1933 Act was to ensure (1) the full disclosure of material information in the markets, (2) the protection of investors against fraud, and (3) to promote ethical standards of honesty and fair dealings.<sup>4</sup> The 1934 Act, aimed at protecting investors against manipulation of stock prices through regulation of transactions, imposed reporting requirements.<sup>5</sup> Arguably its biggest overhaul was the creation of the Security Exchange Commission (SEC)<sup>6</sup>, “which is provided with an arsenal of flexible enforcement powers.”<sup>7</sup>

Congruent with this reasoning, Congress enacted as part of the 1934 Act a “catchall provision”<sup>8</sup> – Section 10(b) – making fraudulent activity unlawful “in connection with the purchase or sale of any security.”<sup>9</sup> Under its authority from Section 10(b), the SEC promulgated Rule 10b-5 making it unlawful, *inter alia*, to “omit to state a *material fact* necessary in order to make the

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<sup>1</sup> 15 U.S.C. § 77a *et seq.* (2015).

<sup>2</sup> 15 U.S.C. §78a *et seq.* (2015).

<sup>3</sup> Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976).

<sup>4</sup> See H.R. Rep. No. 85, 73d Cong., 1<sup>st</sup> Sess., 1-5 (1933).

<sup>5</sup> See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976) (citing *S. Rep. No. 792*, 73d Cong., 2d Sess., 1-5 (1934).

<sup>6</sup> 15 U.S.C. § 78d (2015).

<sup>7</sup> See *H.R. Rep. No. 85*, 73d Cong., 1<sup>st</sup> Sess., 1-5 (1933).

<sup>8</sup> *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) (“Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”); see also *Orn. V. East Dillion, Union Sec. & Co.*, 364 F. Supp. 352 (C.D.C.A. 1973) (“Rule 10b-5 is a general anti-fraud rule which covers a broad range of conduct.”).

<sup>9</sup> 15 U.S.C. § 78j(b)

statements made . . . not misleading”<sup>10</sup> (emphasis added). Allowing for a private right of action, Section 10(b) grants shareholders alleging loss, to sue a registrant company and/or its officers.<sup>11</sup>

A successful suit under Section 10(b) is not easy. As a threshold matter, a plaintiff must prove that the speaker had an affirmative duty to speak truthfully.<sup>12</sup> Once established, the *prima facie* elements must be met: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) causation; (4) reliance; (5) economic loss; and (6) loss causation.<sup>13</sup>

The SEC enacted S-K Item 303, Management Discussion and Analysis (hereinafter “Item 303”).<sup>14</sup> Item 303 is part of Regulation S-K, which is a required disclosure statement which is part of various shareholder reports.<sup>15</sup> It provides opportunity for shareholders and potential shareholders to see a “bird’s eye view” of the registrant company, requiring the sharing of information which management knows may affect the company’s share price.<sup>16</sup> Although plaintiffs do not seem to have the right to sue a company for violations of Item 303,<sup>17</sup> Item 303 has been considered a duty to disclose, triggering liability under various sections of the Act.<sup>18</sup>

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<sup>10</sup> 17 C.F.R. § 240.10b-5 (2016).

<sup>11</sup> *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1317 (2011) (citing *Tellabas, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 318 (2007)).

<sup>12</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

<sup>13</sup> *E.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008).

<sup>14</sup> 17 CFR § 229.303(a)(3)(ii) (2015), which provides:

Describe 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. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed.

<sup>15</sup> *See generally*, 17 C.F.R. § 229 (2016).

<sup>16</sup> *See* 17 C.F.R. § 229.303.

<sup>17</sup> *See In re Burlington Sec. Litig.*, 114 F.3d at 1419 n.7 (noting that “it is an open issue whether violations of Item 303 create an independent cause of action for private plaintiffs.”); *but see Oran v. Stafford*, 226 F.3d 275, 287 (3d Cir. 2000) (quoting *Burlington* and ruling, based on the language of Item 303 and SEC interpretative releases construing Item 303 that no private right of action for Item 303 exists).

<sup>18</sup> *See e.g.*, *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706 (2d Cir. 2011) (finding liability under §§ 11 (registration statement) and 12a2 (prospectus) for Item 303 omissions); *Panther Partners Inc. v. Ikanos Communs., Inc.*, 681 F.3d 114 (2d Cir. 2012).

This note will examine the question of whether Item 303 should provide a duty to disclose for the purposes of Section 10(b) liability and the confusion the courts have when addressing this issue. Part I will describe the various materiality tests applied when analyzing Section 10-b and Rule 10b-5 claims. Part II will describe the SEC’s Item 303 duty to disclose. In Part III, we will examine the Third Circuit holding in *Oran v. Stafford*<sup>19</sup> which forms the essence of the recent circuit split between the Second<sup>20</sup> and Ninth<sup>21</sup> Circuits regarding whether an Item 303 duty to disclose has relevance to a Section 10(b) claim. Part IV will suggest that the Circuit Courts misunderstood the relationship between Section 10(b)’s materiality standard and the threshold duty to disclose as required by the Supreme Court in *Basic, Inc. v. Levinson*.<sup>22</sup> Therefore, an Item 303 duty to disclose should per se meet the threshold requirement of Section 10(b), allowing for an adequately pled claim where the residual Section 10(b) elements have been satisfied. The question of whether an Item 303 omission is “material” should be addressed only after ascertaining that an Item 303 duty to disclose has been established.

## **Part I**

### *A. Section 10(b) and Rule 10b-5*

Congress enacted Section 10(b) as a “catchall provision,”<sup>23</sup> declaring it unlawful to “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.”<sup>24</sup> The Supreme Court has noted that Section 10(b)’s interpretation should be

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<sup>19</sup> 226 F.3d 275 (3d Cir., 2000).

<sup>20</sup> *Stratte-McClure v. Stanley*, 776 F.3d 94 (2d Cir. 2015).

<sup>21</sup> *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014), *cert denied*, *Cohen v. NVIDIA Corp.*, 2015 U.S. LEXIS 3522 (U.S., May 26, 2015).

<sup>22</sup> 485 U.S. 224, 239 n.17 (1988).

<sup>23</sup> *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) (“Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”).

<sup>24</sup> 15 U.S.C. § 78j(b) (2015).

“flexible . . . for its remedial purposes.”<sup>25</sup> Pursuant to its authority under Section 10(b), the Securities Exchange Commission (“SEC”) promulgated Rule 10b-5 (“Rule 10b-5”) which makes it unlawful to “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading.”<sup>26</sup>

*i. Threshold Questions: Private Right of Action, Duty to Disclose*

The question of whether Section 10(b) contains a private right of action has been long settled in the affirmative.<sup>27</sup> However, this ability for private citizens to become proxy-Attorney Generals and police the markets is not absolute. To have standing to sue under Section 10(b), plaintiffs must be either purchasers or sellers of the security in question.<sup>28</sup>

As a threshold matter, the Supreme Court has required that a defendant be under a duty to disclose the omitted information at issue.<sup>29</sup> This means that to successfully state a Section 10(b) claim, the plaintiff must first show there was an affirmative duty to disclose the information and that the company’s breach of that duty was misleading to its financial condition. “Misleading” has been defined as “factually inaccurate, or additional information is required to clarify it.”<sup>30</sup> After such a showing, the plaintiff must show that the defendant’s actual disclosure was a “misrepresentation or omission of material fact.”<sup>31</sup>

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<sup>25</sup> *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972).

<sup>26</sup> 17 C.F.R. § 240.10b-5 (2016).

<sup>27</sup> *See e.g.*, *Basic*, 485 U.S. at 231 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976)).

<sup>28</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975).

<sup>29</sup> *Basic*, 485 U.S. at 239 n.17 (1988) (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5.”); *see e.g.*, *Stratte-McClure v. Stanley*, 776 F.3d 94, 101 (2d Cir. 2015) (quoting *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) that “an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts.”); *but see* *Cohen v. NVIDIA Corp.*, 768 F.3d 1046, 1054 (9<sup>th</sup> Cir. 2014) (“The [Basic] Court did not explain what would give rise to a duty to disclose.”); *see infra* notes 137-38 and accompanying text.

<sup>30</sup> *In re Cybershop.com Sec. Litig.*, 189 F.Supp.2d 214, 224-225 (quoting *In re Nice Sys., Ltd. Sec. Litig.*, 135 F. Supp. 2d 551, 573 (D.N.J. 2001); *Campbell Soup*, 145 F. Supp. 2d 574, 583 (D.N.J. 2001)).

<sup>31</sup> *E.g.*, *In re Cybershop.com Sec. Litig.*, 189 F. Supp. 2d 214, 224 (D.N.J. 2002) (citing *EP MedSystems, Inc. v. EchoCath, Inc.*, 235 F.3d 865, 871 (3d Cir. 2000)); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 537 (3d Cir. 1999).

*ii. Materiality: The Vain Judicial Search for a Simple Formulaic Test*

Once an affirmative duty to disclose has been shown, the plaintiff has the burden to prove the five *prima facie* elements of Section 10(b) and Rule 10b-5, which are: “(1) defendant made a misrepresentation or omission of material fact; (2) scienter motivated defendant's representation or omission; (3) defendant made that representation or omission in the context of a securities purchase or sale; (4) plaintiff relied on defendant's representation or omission; and (5) plaintiff's reliance proximately caused damages.”<sup>32</sup> The last four elements of a Section 10(b) are beyond the scope of this note.

Concerning the first element, the definition of what constitutes “material” has been at the heart of much case law. The Supreme Court has defined “material,”<sup>33</sup> but the issue still remains ambiguous. Admittedly – and for good reason – courts have been reluctant to establish a bright-line test for materiality under Section 10(b).<sup>34</sup> Instead, they have used one of three balancing tests<sup>35</sup> in determining whether information is “material” for Section 10(b).

Citing to legislative record, the Supreme Court noted that “[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.”<sup>36</sup> Reasonable in substance, such

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<sup>32</sup> *Id.*

<sup>33</sup> See *infra* notes 42-63 and accompanying text.

<sup>34</sup> See *e.g.*, *Lit-win v. Blackston Grp., L.P.*, 634 F.3d 706, 717 (2d Cir. 2011) (quoting 64 Fed. Reg. at 45, 151 that the usage of a numerical threshold to prove materiality); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 236, n.14 (1988)).

<sup>35</sup> See *infra* notes 43-63 and accompanying text.

<sup>36</sup> *Basic*, 485 U.S. at 236, 236 n.14 (citing House Committee on Interstate and Foreign Commerce, Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong., 1st Sess., at 327 (Comm. Print 1977)); see also FASB, Statement of Financial Accounting Concepts No. 2, P 125 (1980) (“Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.”).

an outlook significantly complicates things behind the bench and on both sides of the “v.”<sup>37</sup> For judges (and juries), an individualized, holistic approach must be taken to determine whether the information omitted is material. Similarly situated plaintiffs, even in the same jurisdiction, are not guaranteed equal treatment because of a subjective governing standard. Defendants are also not guaranteed a favorable outcome based on precedent and must be prepared to convince a judge that the malleable materiality standard sways in their favor. Those same corporate defendants, while in the privacy of their board rooms, must walk the tightrope in making required disclosures, attempting to strike a delicate balance between what must be disclosed, what need not be disclosed, and whether those considerations may place them on the wrong side of a difficult and costly law suit.

Besides making actionable cases based on affirmative misstatements, Section 10(b) attaches liability to the omission of material information as well.<sup>38</sup> When a defendant has a duty to disclose information,<sup>39</sup> that duty requires a full and accurate disclosure.<sup>40</sup> Courts have taken one of three approaches, discussed below,<sup>41</sup> in deciding whether that information is material or not.

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<sup>37</sup> Basic, 485 U.S. at 236 (1988) (“A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions.”)

<sup>38</sup> 17 C.F.R. § 240.10b-5 (2016) (“It shall be unlawful for any person . . . to make any . . . omi[ssion of] material fact. . . .”).

<sup>39</sup> See *supra*, note 30 and accompanying text.

<sup>40</sup> SEC v. Conaway, 698 F. Supp. 2d 771, 827-28 (E.D.M.I. 2010) (quoting Rubin v. Schottenstein, 143 F.3d 263, 268 (6th Cir. 1998) (en banc) (“a party who discloses material facts in connection with securities transactions assumes a duty to speak fully and truthfully on those subjects.”) (internal citations omitted)

<sup>41</sup> See notes 43-63 and accompanying text.

a. Northway – the “Reasonable Investor”/“Total Mix” Standard

In formulating a materiality standard, the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*<sup>42</sup> welcomed the “reasonable investor” into the courtroom, asking him whether there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by [him] as having significantly altered the ‘total mix’ of information available.”<sup>43</sup> The Third Circuit rephrased the *Northway* inquiry in *In re Burlington Coat Factory Securities Litigation*, noting that “[o]rdinarily, the law defines ‘material’ information as information that would be important to a reasonable investor in making his or her investment decision.”<sup>44</sup> However, plaintiffs are not required to prove that a reasonable investor would have acted differently had the disclosure been accurate.<sup>45</sup> Rather, “misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.”<sup>46</sup> Broad as it is, this standard is not all-encompassing. Indeed, “material representations must be contrasted with statements of subjective analysis or extrapolations, such as opinions, motives and intentions, or general statements of optimism, which constitute no more than puffery and are understood by reasonable investors as such.”<sup>47</sup>

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<sup>42</sup> 426 U.S. 438 (1976).

<sup>43</sup> *Id.* at 449 (1976).

<sup>44</sup> 114 F.3d 1410, 1425 (2d Cir. 1997).

<sup>45</sup> *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000).

<sup>46</sup> *Id.* (quoting *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985)); see also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976) (noting that even at the summary judgment stage, the “determination [of materiality] requires delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact”).

<sup>47</sup> See e.g., *In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 583-84 (D.N.J. 2001) (citing *EP MedSystems*, 235 F.3d at 872 (quoting *Advanta*, 180 F.3d 525 at 538) (internal quotations omitted)).



b. Burlington – “Efficient Market”/“Effecting Share Price” Test

A second, “alternative standard”<sup>48</sup> was announced by the Third Circuit in *Burlington*.<sup>49</sup> The Burlington test for materiality recognizes that “efficient markets are those in which information important to reasonable investors . . . is immediately incorporated into stock prices is based on the premise that in efficient markets, share prices have already internalized information which is important to reasonable investors.”<sup>50</sup> According to this test, materiality can be assessed by looking backward at the change in stock price that caused the eventual disclosure.<sup>51</sup> When prices remain stable following a subsequent disclosure, “this price stability is dispositive of the question of materiality.”<sup>52</sup> However, a sharp downward turn in share price immediately following the complete disclosure may not be dispositive of whether the information is material.<sup>53</sup>

The author is not entirely certain that the *Northway* and *Burlington* are two separate tests for materiality. The Second Circuit introduces the *Northway* test by using the word “ordinarily”, and says “[o]rdinarily, the law defines ‘material’ information as . . .”<sup>54</sup> The word “ordinarily” coupled with an explanation of one standard and then immediately followed by a second standard connotes two entirely different standards. This seems to be the reading which the District of New Jersey in *In re Campbell Soup Company Securities Litigation*<sup>55</sup> understood the *Burlington* opinion,

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<sup>48</sup> *Id.* at 583.

<sup>49</sup> *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (2d Cir. 1997).

<sup>50</sup> *Id.*

<sup>51</sup> *Campbell Soup*, 145 F. Supp. 2d at 584 (quoting *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (“As a result, when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following [the] disclosure, of the price of the firm’s stock.”)); see e.g., *Oran v. Stafford*, 34 F. Supp. 2d 906, 911 (D.N.J. 1999) (noting that information, when disclosed, did not result in a change in share price was immaterial as a matter of law), *aff’d in Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).

<sup>52</sup> *Oran v. Stafford*, 226 F.3d at 283.

<sup>53</sup> See *In re AT&T Corp. Sec. Litig.*, 2004 U.S. Dist. LEXIS 29588 at \*46 (D.N.J. Sep. 2, 2004) (noting the largest historical drop in the stock’s history – \$3/share – still leaves open for dispute “whether the . . . disclosures . . . as a whole were material . . .”)

<sup>54</sup> *Burlington*, 114 F.3d at 1425 (emphasis added).

<sup>55</sup> *Campbell Soup*, 145 F. Supp. 2d 574, 583 (D.N.J. 2001).

in referring to the *Burlington* standard as “alternate”. However, it is possible to read *Burlington* as expounding upon the *Northway* test and saying that “material” information which a reasonable investor would be interested in knowing regarding making investment decisions is that which, “[i]n the context of an ‘efficient market’” will alter the share price. *Id.* Considering the language which the *Burlington* court uses to connect the *Northway* standard with their own (“[o]rdinarily, . . . , [i]n the context of an ‘efficient market’ . . . .”), it could be narrowing the *Northway* standard noting that when applicable to “efficient markets,” the proper application of the *Northway* standard is that which effects the share price. However, according to the language of the *Northway* standard (“information which would alter the ‘total mix’ of information available”) itself (and not to how it was rephrased in *Burlington*, “altered the ‘total mix’ of information available”) can be interpreted as a standard different than *Burlington*, because there is more information that may alter the “total mix” of information available than what specifically will – looking retrospectively – affect the share price.

*c. Back to “Basics” – the “Probability/Magnitude” Test*

A third materiality test was set forth by the Supreme Court in *Basic, Inc. v. Levinson*,<sup>56</sup> applicable to cases of “contingent or speculative information or events.”<sup>57</sup> Quoting the Second Circuit in *SEC v. Texas Gulf Sulphur Company*,<sup>58</sup> the Supreme Court said that a statement is material for Section 10(b) considering “a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”<sup>59</sup> Commonly referred to as the “probability/magnitude test,”<sup>60</sup> this standard governs

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<sup>56</sup> 485 U.S. 224 (1988).

<sup>57</sup> *Id.* at 239.

<sup>58</sup> 301 F.2d 833, 849 (CA2 Cir. 1968).

<sup>59</sup> *Basic*, 485 U.S. at 238.

<sup>60</sup> *See e.g.*, 54 Fed. Reg. 22,427, 22,430 n.27 (May 24, 1989).

Section 10(b) omission cases.<sup>61</sup> Differing from the *Northway* and *Burlington* tests, the probability/magnitude test requires a detailed look at the information in determining whether Section 10(b) fraudulent practices were present. This is so because it is a two-prong test requiring the balancing of (1) the probability of event occurring, and (2) anticipated magnitude, considering the company's total activity. Those best suited to assess the probability of an event are those people who have inside information about the company and are privy to inside information. Similarly, the cold, hard facts required for a determination of the magnitude of a possible event having on the company as a whole is held by insiders to the corporation. Reasonable in that regard because it considers materiality with respect to "contingent or speculative information or events,"<sup>62</sup> it presents a difficult burden for the plaintiff to bear.

## Part II

### A. Item 303

Item 303 of Regulation S-K, also known as the "Management Discussion and Analysis" (MD&A) requires companies to make narrative disclosures about forward-looking information to their shareholders.<sup>63</sup> Specifically, companies must "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a *material . . . impact* on net sales or revenues or income from continuing operations."<sup>64</sup> Instruction 3 of Item 303 explains further by mentioning that "the discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be

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<sup>61</sup> See e.g. *Stratte-McClure v. Stanley*, 776 F.3d 94, 103 (2d Cir. 2015) ("a plaintiff must first allege that the defendant failed to comply with Item 303 in a 10-Q or other filing. . . . A plaintiff must then allege that the omitted information was material under Basic's probability/magnitude test, because 10b-5 only makes unlawful an omission of material information" that is "necessary to make . . . statements made, . . . not misleading.").

<sup>62</sup> *Basic*, 485 U.S. at 239.

<sup>63</sup> Exchange Act Release No. 6835, 1989 SEC LEXIS 1011, at \*17.

<sup>64</sup> 17 C.F.R. § 229.303(a)(3)(ii) (2016) (emphasis added).

necessarily indicative of future operating results or of future financial condition.”<sup>65</sup> The SEC has further elaborated on Item 303 disclosure duty:

Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

(1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.<sup>66</sup>

Circuit Courts are split on whether Item 303 is sufficient for the threshold requirement of a duty to disclose under Section 10(b).<sup>67</sup> Additionally, the question of whether once an Item 303 duty to disclose is established, can the omission satisfy Section 10(b)'s first element of “misrepresentation or omission of material fact”<sup>68</sup> where its own materiality test has been met. Earlier this year, the Supreme Court denied cert to review a Ninth Circuit decision which might have answered this circuit split.<sup>69</sup> Policy and caselaw seem to support the conclusion that Section 10(b) litigation should be interpreted expansively to include Item 303 omissions as a duty to disclose – albeit not regarding the issue of materiality, rather concerning the duty to disclose – as described below.<sup>70</sup>

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<sup>65</sup> *Id.* at instr. 3.

<sup>66</sup> Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 34-26831, 54 Fed. Reg. 22427, 22430 (May 24, 1989).

<sup>67</sup> See e.g., *Stratte-McClure v. Stanley*, 776 F.3d 94 (2d Cir. 2015); *In re NVIDIA Corp. Sec. Litig.*, 226 F.3d 275 (3d Cir. 2000).

<sup>68</sup> *E.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008).

<sup>69</sup> *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014), *cert denied*, *Cohen v. NVIDIA Corp.*, 2015 U.S. LEXIS 3522 (U.S., May 26, 2015).

<sup>70</sup> See *infra*, Part IV.

### Part III – The Circuit Split

In recent cases, the Second<sup>71</sup> and Ninth<sup>72</sup> Circuits disagreed on the treatment of Item 303 omission in Section 10(b) cases. Interestingly, the circuit split revolves in part around the correct interpretation of fifteen year-old Third Circuit precedent.<sup>73</sup>

#### *a. The Oran v. Stafford Case*

In *Oran v. Stafford*,<sup>74</sup> then-Judge Alito, directly addressed the treatment of Item 303 in Section 10(b) cases. In *Oran*, the American Home Products Corporation (“AHP”) delayed disclosing data in their SEC filings regarding the connection between two prescription weight-loss drugs manufactured and sold by AHP and heart-valve disorders. Plaintiffs sued AHP, alleging, *inter alia*, that the information was fraudulently omitted from multiple SEC disclosure reports.<sup>75</sup> The Third Circuit found that, because the data was inconclusive, the omitted information was not material. Although a significant price-drop followed the (eventual) full disclosure, the *Burlington* test was not satisfied because APH was under no duty to disclose the information, and “silence, absent a duty to disclose, is not misleading under Rule 10b-5.”<sup>76</sup> It is important to note: since the *Oran* Court held the omitted information to be immaterial, it needed not proceed in its Item 303 and Section 10(b) analysis. Although it is persuasive precedent,<sup>77</sup> *Oran*’s remaining analysis – helpful as it is (or isn’t) – is merely dicta, as it is unnecessary to its actual holding.

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<sup>71</sup> *Stratte-McClure*, 776 F.3d 94.

<sup>72</sup> *NVIDIA*, 768 F.3d 1046.

<sup>73</sup> *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).

<sup>74</sup> 226 F.3d 275 (3d Cir. 2000).

<sup>75</sup> *Oran*, 226 F.3d at 287.

<sup>76</sup> *Id.* at 285 (3d Cir. 2000) (citing *Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988)).

<sup>77</sup> *See e.g. NVIDIA*, 768 F.3d 1046 (9th Cir. 2014) (“In *Oran v. Stafford*, the Third Circuit decided this issue [whether Item 303 creates a duty to disclose for securities fraud actions] more directly. We are persuaded by its reasoning.”); *Ash v. PowerSecure Int’l, Inc.*, 2015 U.S. Dist. LEXIS 122692, \*27 (E.D.N.C. Sept. 15, 2015) (“In *Oran*, the Third Circuit considered whether Item 303 imposed on the defendant an ‘affirmative obligation to disclose,’ under section 10(b) and Rule 10b-5.”)

Looking to the congressional intent, the Court reasoned that the establishment of Item 303 did not create a private right of action and that case law from other circuits rejected this position.<sup>78</sup> AHP was under a duty to disclose the information pursuant to Item 303.<sup>79</sup> Next, the court rejected the argument that Item 303 creates a duty to disclose which is actionable under Section 10(b).<sup>80</sup> At this point in the opinion, it seems that there is some confusion in either the opinion itself or in its interpretation between Item 303 as a duty to disclose and satisfying *Basic*'s probability/magnitude test. The opinion first compared an Exchange Act Release with the *Basic* standard.<sup>81</sup> Quoting a footnote to the Exchange Act Release and a District Court case from the Ninth Circuit, the *Oran* Court held that the “demonstra[tion] of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure should be required under Rule 10b-5. Such a duty to disclose must be separately shown.”<sup>82</sup>

#### A. *The Oran v. Stafford Holding*

The *Oran* Court could have spared a lot of heartache and ink by finding that the information omitted by AHP was immaterial as a matter of law and therefore, no liability attaches to its omission under securities laws. However, as mentioned before, its dicta has become legendary in the world of Item 303 and Section 10(b).

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<sup>78</sup> *Oran*, 226 F.3d at 287 (citing *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 402 (6th Cir. 1997); *In re Boston Tech., Inc., Sec. Litig.*, 8 F. Supp. 2d 43, 67 (D. Mass. 1998); *In re Canandaigua Sec. Litig.*, 944 F. Supp. 1202, 1209 n.4 (S.D.N.Y. 1996); *In re F&M Distrib., Inc. Sec. Litig.*, 937 F. Supp. 647, 654 (E.D. Mich. 1996); *Kriendler v. Chemical Waste Mgmt., Inc.*, 877 F. Supp. 1140, 1157 (N.D. Ill. 1995)).

<sup>79</sup> *Oran*, 226 F.3d at 286 n. 6.

<sup>80</sup> *Id.* at 287.

<sup>81</sup> *Id.* at 287-88.

<sup>82</sup> *Id.* at 288 (quoting *Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 608 (N.D. Cal. 1991)); *see also* *Sofamor*, 123 F.3d at 402; *In re Quintel Entertainment, Inc., Sec. Litig.*, 72 F. Supp. 2d 283, 293 (S.D.N.Y. 1999); *Wilensky v. Digital Equip. Corp.*, 903 F. Supp. 173, 181 & n.10 (D. Mass.1995), *rev'd in part on other grounds sub nom*, *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194 (1st Cir. 1996); *Kriendler*, 877 F. Supp. at 1157.

*i. Back to Basics – Separating Section 10(b) Materiality from Item 303*

As mentioned before, the *Oran* opinion does not make a clear distinction between the question of whether Item 303 is a duty to disclose which satisfies the threshold requirement of Section 10(b) and the subsequent issue of satisfying Section 10(b)'s element of materiality. The confusion seems to stem from the language of each respective requirement. Item 303 requires the disclosure of information which is reasonably believed by the registrant to have a material effect on the future financial condition of the company.<sup>83</sup> The *Basic* materiality test questions whether information that has been independently established as requiring disclosure, is “material.”<sup>84</sup> This is seemingly what is intended by the Exchange Release Act<sup>85</sup> in saying that the *Basic* test is “inapposite” to Item 303 disclosure. The two tests are irrelevant because they discuss two different aspects of Section 10(b) litigation. The Item 303 test concerns the duty to disclose the information.<sup>86</sup> This is a prior inquiry before considering *Basic*'s materiality assessment, which is considered *after* a duty to disclose has been established. Additionally, the *Alfus* decision famously quoted by the *Oran* court that “[s]uch a duty to disclose [under Section 10(b), apart from Item 303] must be separately shown,”<sup>87</sup> is out of context. As noted above, first a plaintiff must prove that the registrant was under a duty to disclose the information. Then an assessment of the materiality of the omitted statement is required. However, the court in *Alfus* speaks about a Section 10(b) disclosure requirement. Section 10(b) is violated when the registrant employs “any manipulative or deceptive device or contrivance”<sup>88</sup> which includes omissions. It does *not* create a duty to

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<sup>83</sup> 17 C.F.R. § 229.303(a) instruction 3.

<sup>84</sup> *Basic, Inc. v. Levinson* 485 U.S. 224, 238 (1988).

<sup>85</sup> Exchange Act Release No. 34-26831, 54 Fed. Reg. at 22430 n.27.

<sup>86</sup> Exchange Act Release No. 6835, 1989 SEC LEXIS 1011, at \*17.

<sup>87</sup> *Oran* at 288 (quoting *Alfus v. Pyramid Tech. Corp.*, 764 F. Supp. 598, 608 (N.D. Cal. 1991)).

<sup>88</sup> 15 U.S.C. § 78j(b) (2015).

disclose information,<sup>89</sup> rather attaches civil liability to someone “engag[ing] in any act, practice, or course of business which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”<sup>90</sup>

That being said the *Basic* materiality test does “differ significantly” in its analysis than Item 303. A careful reading of each respective authority shows the difference. In determining an Item 303 duty to disclose, the SEC requires a two-prong analysis,<sup>91</sup> which is a step-by-step determination and differs from the *Basic* sliding scale determination. First, is the event “likely to come to fruition?”<sup>92</sup> This is assessed without regard to the effect it will have on the company. Where an affirmative determination can be made that the event is “not reasonably likely to occur,”<sup>93</sup> there need not be disclosure. However, the second prong (reached when such an affirmative determination cannot be made) asks management to make an objective evaluation of the consequences of the event. Disclosure is required unless an affirmative determination can be made that a “material effect on the registrant’s financial condition . . . is not reasonably likely to occur.”<sup>94</sup>

Alternatively, *Basic*’s probability/magnitude test is a sliding scale, considering (1) the probability of the event occurring and (2) its magnitude to the overall operations of the company. Therefore, an event that has a large probability of occurring but will not have a large effect on the company’s operations may be considered fraudulent to withhold. Conversely, as well, an event

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<sup>89</sup> See SEC v. Conaway, 698 F. Supp. 2d 771 (E.D. Mich. 2010) (“The 1934 Congress in the Securities Act created a duty to speak in the reporting requirements of § 13(a), and in Section 10(b) prohibited deceptive devices . . . for the protection of investors.”); *id.* at 838 n. 56.

<sup>90</sup> 17 C.F.R. § 240.10b-5(c) (2015).

<sup>91</sup> Management’s Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 34-26831, 54 *Fed. Reg.* 22427, 22430 (May 24, 1989).

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*



which threatens to completely ruin the company but its chances are worse than winning the lottery also may be considered fraudulent to withhold.

Contrary to the Third Circuit's opinion in *Oran*, the Second Circuit, in *In re Scholastic Corp. Securities Litigation*<sup>95</sup> noted that "plaintiffs were held to a more stringent standard [by the District Court] than the law requires" because an Item 303 omission was not considered by the District Court to be adequately plead Section 10(b) claim.<sup>96</sup> Later courts have latched onto this line, equivocal as it is, as contrary authority to *Oran*'s (possible) inability to find a Section 10(b) claim where there was merely an alleged Item 303 violation.<sup>97</sup>

*ii. Oran's "Separate Showing"*

The interpretation of *Oran* is not as clear-cut as suggested above. One issue of the circuit split has been the correct interpretation of what is the "separate" showing required for Section 10(b) that is beyond the elements establishing an Item 303 duty to disclose. The simple reading of *Oran* suggests that the "separate showing" is the *Basic* materiality test is required, in addition to the threshold duty to disclose question. This would explain why the "demonstration 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."<sup>98</sup> Such a reading is consistent with the Second Circuit's holding in *Glazer v. Formica Corp.*, quoted by *Oran*<sup>99</sup> that a regulation can serve as a duty to disclose under Section 10(b). Under this analysis, Item 303 is sufficient to create a duty to disclose and then the *Basic* probability/magnitude materiality test must also be shown.

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<sup>95</sup> 252 F.3d 63 (2d Cir. 2001).

<sup>96</sup> *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 70 (2d Cir. 2001).

<sup>97</sup> See e.g., *In re Corning Inc., Sec. Litig.*, 349 F. Supp. 2d 698, 717 (S.D.N.Y. 2004); see *SEC v. Conaway*, 698 F. Supp. 2d 771, 841 (E.D.M.I. 2010) ("While the issue discussed above is hardly the "holding" in *Scholastic*, other courts cite it as if it is.").

<sup>98</sup> *Oran*, 226 F.3d at 288 (3d Cir. 2000).

<sup>99</sup> *Id.* at 285-86 (quoting *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992)).

This reading was adopted by the District Court for the Southern District of New York in *In re Corning Securities Litigation*, noting:

Considering *Rule 10b-5* in conjunction with SK-303 . . . , *it is perfectly clear how the law applies to the present case*. If at the time the financial statements . . . were issued, Corning knew of potential liabilities . . . , and knew that these liabilities were potentially of such a size *as to materially affect the future earnings of Corning and the general financial condition of Corning, the law required Corning to disclose this*. Such a disclosure would have undoubtedly taken the form of a charge against income *as well as a description of the circumstances*. . . . *Failure to make such a disclosure would be failure to state material facts, thus creating liability under Rule 10b-5*.<sup>100</sup>

Note that the *Corning* court did not mention the *Basic* test in the context of determining a duty to disclose, rather it is using the test to “creat[e] liability under Rule 10b-5.”<sup>101</sup> It is possible to explain this holding as respecting the fact that first a plaintiff must prove that the registrant had a duty to disclose the information. Only afterwards should the *Basic* probability/magnitude test be considered.

This is how the Second Circuit understood *Oran* earlier this year in *Stratte-McClure v. Stanley*.<sup>102</sup> In *Stratte-McClure*, the plaintiff sued under Section 10(b), alleging that the defendant Morgan Stanley failed to disclose the existence of a proprietary investment position which left them particularly vulnerable to the housing market bubble that peaked in 2006.<sup>103</sup> After finding that defendants were obligated to disclose their investment position pursuant to Item 303,<sup>104</sup> the court held that Item 303 can serve as a duty to disclose under Section 10(b), setting the stage for a pleading of Section 10(b)’s elements<sup>105</sup>

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<sup>100</sup> 349 F. Supp. 2d 698, 717 (S.D.N.Y. 2004) (emphasis added); *see also* Conaway, 698 F. Supp. at 842 (quoting *Corning*).

<sup>101</sup> *Corning*, 349 F. Supp. 2d at 717.

<sup>102</sup> 776 F.3d 94 (2d Cir. 2015).

<sup>103</sup> *Id.* at 97.

<sup>104</sup> *Id.* at 101.

<sup>105</sup> *Id.* at 103.

including *Basic*'s materiality test. After citing the Ninth Circuit's interpretation of *Oran*,<sup>106</sup> the *Stratte-McClure* court noted that *Oran* first established that the omissions were not material as a matter of law because the information was inconclusive<sup>107</sup> and then decided that Item 303 could not provide a basis for liability.<sup>108</sup> However, the *Stratte-McClure* court opined that *Oran* leaves open the possibility that Item 303 duties to disclose "could give rise to a material 10b-5 omission."<sup>109</sup>

Prior to the Second Circuit's holding in *Stratte-McClure*, the Ninth Circuit, in *In re NVIDIA Corp. Securities Litigation*,<sup>110</sup> read the *Oran* opinion that Item 303 is never actionable under Section 10(b).<sup>111</sup> Using the language of the Exchange Release Act that the Item 303 test is "inapposite" to Section 10(b),<sup>112</sup> the Ninth Circuit held that the "separate" showing required by *Oran* takes Item 303 out of the Section 10(b) universe completely. The Second Circuit disagreed with this reading of *Oran*, and suggested that the Third Circuit "at a minimum is consistent with our decision that failure to comply with Item 303 . . . can give rise under Rule 10b-5."<sup>113</sup>

Interestingly, although there has been much case law citing to the *Oran* opinion since it was decided in 2000, there is very little case law explaining the holding<sup>114</sup> until

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<sup>106</sup> See *infra*, notes 111-124 and accompanying text for a detailed discussion and analysis of the NVIDIA court's position.

<sup>107</sup> *Supra*, Part I.

<sup>108</sup> *Stratte-McClure*, 776 F.3d at 103 (internal citations omitted).

<sup>109</sup> *Id.*

<sup>110</sup> 768 F.3d 1046 (9th Cir. 2014).

<sup>111</sup> *Id.*, at 1054.

<sup>112</sup> Exchange Act Release No. 34-26831, 54 *Fed. Reg.* at 22430 n.27.

<sup>113</sup> *Stratte-McClure*, 776 F.3d at 103-104.

<sup>114</sup> *SEC v. Conaway*, 698 F. Supp. 2d 771, 842 (E.D.M.I. 2010) ("While these cases cited by Plaintiff in support of its position are fewer in number than those cited by the Defendant, all of the cases, with the exception of *Oran*, share one thing in common -- they all seem merely to state their position as a given, some citing *Oran* or *Scholastic* to support their differing results, but none of them provide any analysis of the reasons why Item 303, in certain circumstances, should or should not provide a basis for 10b-5 liability.").

this recent circuit split. In *SEC v. Conaway*, the District Court for the Eastern District of Michigan suggested:

if *Oran* should be read as always excluding Item 303 from providing a basis for 10b-5 liability, then it is believed that the Sixth Circuit will reject such an extreme position and will rather follow the lead of the Second Circuit in *Scholastic*, possibly articulating some clear limits and guidelines.<sup>115</sup>

Unfortunately, no “clear limits and guidelines” have yet to be set.

One problem with the *NVIDIA* reading of *Oran* is that it reads Item 303 of the Exchange Act Release to trump the *Glazer* Court<sup>116</sup> that a regulation can provide the threshold duty to disclose required for securities litigation under *Basic*. This does not seem so problematic, because *Glazer* is merely persuasive Second Circuit precedent. However, the Third Circuit accepted the rule that regulations can provide a duty for Section 10(b). It is equally feasible to understand the two authorities in tandem: as the Second Circuit interpreted *Oran*, the Exchange Act Release merely mentions that a duty to disclose under Item 303 does not *automatically* create a Section 10(b) duty to disclose. It therefore seems that the *Stratte-McClure*<sup>117</sup> reading of *Oran* is simpler and more reasonable than the *NVIDIA* reading.

In a recent case, the District Court for the Eastern District of North Carolina, in *Ash v. PowerSecure International, Inc.*<sup>118</sup> vehemently opposed the *Stratte-McClure* reading of *Oran*, accepting the *NVIDIA* court’s interpretation. The *Ash* Court noted that “Item 303 is not a magic black box in which inadequate allegations under Rule 10b-5 are transformed, by means of broader and different SEC regulations, into adequate allegations under Rule 10b-5”.<sup>119</sup> The *PowerSecure* Court read the Exchange Act Release to say like the conclusion of the *NVIDIA* court:

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<sup>115</sup> *Id.* at 843.

<sup>116</sup> *See supra*, note 100 and accompanying text.

<sup>117</sup> 776 F.3d 94 (2d Cir. 2015).

<sup>118</sup> 2015 U.S. Dist. LEXIS 122692 (E.D.N.C. Sept. 15, 2015).

<sup>119</sup> *Id.* at \*26-29 (citing to Exchange Act Release No. 34-26831, 54 Fed. Reg. 22,427-30 n.27 (May 24, 1989)).

When then-Judge Alito’s statement that ‘a violation of SK-303’s reporting requirements does not automatically give rise to a material omission under Rule 10b-5’ is placed in full context of the discussion, including the significant differences in materiality standards under the two rules, it is apparent that *Oran* required a plaintiff to independently show a duty to disclose under Rule 10b-5 standards.<sup>120</sup>

Thus, the Court read *Oran* as standing for the premise that Item 303 has nothing to do with Section 10(b) liability.

iii. *The Corning Approach: Much More “Basic”*

In *In re Corning, Inc., Securities Litigation*,<sup>121</sup> the District Court for the Southern District of New York relied on the Second Circuit’s holding in *Scholastic*,<sup>122</sup> thereby taking a much simpler approach to the relationship between Item 303 and Section 10(b):

Considering Rule 10b-5 in conjunction with SK-303 and FASB 5, it is *perfectly clear how the law applies to the present case*. If at the time the financial statements in question in this action were issued, Corning knew of potential liabilities of its 50%-owned Dow Corning . . . , and knew that these liabilities were potentially of such a size as to materially affect the future earnings of Corning and the general financial condition of Corning, the law required Corning to disclose this. Such a disclosure would undoubtedly have taken the form of a charge against income as well as a description of the circumstances. Failure to make such a disclosure would be failure to state material facts, thus creating liability under Rule 10b-5.<sup>123</sup>

The Court circumvented the *Oran* materiality-standard differential of Item 303 and Section 10(b), even refusing to read it as allowing for Item 303 to trigger Section 10(b) when the *Basic* test has been met (like the *McClure* court would read the case eleven years later). Instead, it relied on the *Scholastic* authority that Item 303 can trigger a Section 10(b) claim.

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<sup>120</sup> *Id.* (emphasis added) (quoting *Oran*, 226 F.3d at 287-88).

<sup>121</sup> 349 F. Supp. 2d 698 (S.D.N.Y. 2004).

<sup>122</sup> *Id.* at 716 (“the Second Circuit in a subsequent case reversed a district court’s dismissal of a Rule 10b-5 claim that was based on a defendant’s failure to make disclosures allegedly required under SK-303.”).

<sup>123</sup> *In re Corning, Inc., Sec. Litig.*, 349 F. Supp. 2d 698, 717 (S.D.N.Y. 2004).

## Part IV

In declining to grant cert to *In re NVIDIA*<sup>124</sup> the Supreme Court has, for the moment, decided to keep open the question of whether Item 303 creates a duty to disclose for the purposes of Section 10(b). Being that courts have confused the *Basic* duty to disclose<sup>125</sup> with the *Basic* materiality test,<sup>126</sup> they should separate the two. When considered separately, Item 303 should be sufficient to supply a duty to disclose, attaching civil liability under Section 10(b) when its *prima facie* elements have been successfully plead. This separation of duty to disclose and materiality consideration is congruent with the policy behind the enactment of the securities statutes and relevant case law.

### *A. Sweeping it Under the Carpet: Court's Inability to Elaborate Their Item 303 Holdings*

Ruling in this area of law, courts seem to have an aversion to thoroughly explaining their reasoning.<sup>127</sup> That, if nothing else, is enough to raise the proverbial eyebrow. Possibly courts are taking an outcome-specific approach to Section 10(b) litigation congruent with their political view of capitalism and theories of *caveat emptor*. For example, a court whose political leaning is pro-big business would cite *Oran*<sup>128</sup> to put forth the argument that 303 is “inapposite” to the *Basic* materiality test and, similarly to the *NVIDIA* court,<sup>129</sup> absolve companies under Item 303 duties to disclose from Section 10(b) liability. On the other hand, a court interested in increasing liability

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<sup>124</sup> *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014), *cert denied*, Cohen v. NVIDIA Corp., 2015 U.S. LEXIS 3522 (U.S. May 26, 2015).

<sup>125</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

<sup>126</sup> *Id.* at 239.

<sup>127</sup> See *SEC v. Conaway*, 698 F. Supp. 2d 771, 842 (E.D.M.I. 2010) which states, in relevant part:

While these cases cited by Plaintiff in support of its position are fewer in number than those cited by the Defendant, all of the cases, with the exception of *Oran*, share one thing in common -- they all seem merely to state their position as a given, some citing *Oran* or *Scholastic* to support their differing results, but none of them provide any analysis of the reasons why Item 303, in certain circumstances, should or should not provide a basis for Rule 10b-5 liability.

<sup>128</sup> *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000).

<sup>129</sup> *NVIDIA*, 786 F.3d at 1055.

for large companies can cite *Scholastic*<sup>130</sup> or read *Oran*<sup>131</sup> like the *Stratte-McClure*<sup>132</sup> court did, in stating that Item 303 *on its own* will not prove Section 10(b) liability, but can be used in providing a regulatory duty to disclose. Thereby it allows for a plaintiff to plead the other Section 10(b) elements.

It would seem self-evident by the Supreme Court that when it says, “[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5,”<sup>133</sup> that Item 303 should have particular significance in Section 10(b) litigation. Especially considering that the First and Second Circuits have longstanding and oft quoted precedent that “a regulation requiring disclosure” is sufficient to mislead.<sup>134</sup> In fact, it is quite surprising that the Ninth Circuit noted “[t]he [Supreme] Court did not explain what would give rise to a duty to disclose” and refused to find an Item 303 duty to disclose as misleading for Section 10(b).<sup>135</sup>

Under principles of formal logic, the contrapositive of a statement has the same truth value as the statement itself.<sup>136</sup> A contrapositive is defined as “a proposition of theorem formed by contradicting both the subject and predicate . . . and interchanging them. ‘If not-B then not-A’ is the contrapositive of ‘if A then B.’”<sup>137</sup> The Supreme Court’s statement, restated as a formal logic sentence reads: if there is silence and no duty to disclose, then the statement is not misleading. The contrapositive of that sentence reads: if there is a misleading statement, then there has been no silence and an affirmative duty to disclose is created. This means that according to the Supreme

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<sup>130</sup> *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 70 (2d Cir. 2001).

<sup>131</sup> *Oran*, 226 F.3d 275.

<sup>132</sup> *Stratte-McClure v. Stanley*, 776 F.3d 94 (2d Cir. 2015).

<sup>133</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

<sup>134</sup> *See e.g. Glazer*, 964 F.2d at 157 (quoting *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1<sup>st</sup> Cir. 1990)).

<sup>135</sup> *In re NVIDIA Corp. Sec. Litig.*, 769 F.3d 1046, 1054 (9th Cir. 2014) (citing to other cases where “[i]n each instance, we strongly suggested that a violation of Item 303 cannot be used to show a violation of Section 10(b) and Rule 10b-5.”).

<sup>136</sup> <http://www.britannica.com/topic/syllogistic#ref52831> (last visited Jan. 24, 2016).

<sup>137</sup> [www.merriam-webster.com/dictionary/contrapositive](http://www.merriam-webster.com/dictionary/contrapositive) (last visited Dec. 30, 2015).

Court, a duty to disclose information is a necessary condition to make a showing of a “misleading statement” for Section 10(b). Therefore, the Supreme Court, through speaking in the double negative, has explained what gives rise to a duty to disclose.

Nonetheless, courts are reluctant to take the simple and reasonable approach that Item 303 will trigger Section 10(b) liability because: (1) a fear of flood-gate litigation; (2) “flood-gate” disclosures, which threaten to burden both companies and (potential) shareholders; and (3) the fact that the SEC has noted that “[t]he probability/magnitude test for materiality approved by the Supreme Court in [*Basic*] is inapposite to Item 303 disclosure.”<sup>138</sup> However, careful consideration of the general policies behind the enactment of the Securities Exchange Act, an alternate reading of the Securities Exchange Act Release, and a careful approach to these three factors compels the application of Section 10(b) liability where a duty to disclose under Item 303 is shown.

*B. How “Inapposite” is Item 303 to Section 10(b), Really?*

In an Exchange Act Release, the SEC noted that, since Item 303 provides its own disclosure standard and does not rely on the *Basic* probability/magnitude test,<sup>139</sup> “the [*Basic*] test is . . . inapposite to Item 303 disclosure.”<sup>140</sup> To reiterate,<sup>141</sup> this quote could be interpreted that Item 303 can never trigger Section 10(b) liability, or that it has the ability to trigger liability when a *Basic* materiality test concerning the omitted information has been satisfied. However, Item 303 has been found to be “apposite” to other sections of the Securities Exchange Act, and therefore should also apply to Section 10(b).

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<sup>138</sup> 54 Fed. Reg. at 22430 n.27 (May 24, 1989).

<sup>139</sup> 485 U.S. 224 (1988).

<sup>140</sup> 54 Fed. Reg. at 22430 n.27 (May 24, 1989).

<sup>141</sup> See *supra*, notes 128-133 and accompanying text.



In *Litwin v. Blackstone Group, L.P.*, the Second Circuit established that Item 303 provides a duty to disclose information for other sections of the Act,<sup>142</sup> i.e. information relevant to potential buyers of a security in the “prospectus” disclosure document pursuant to Section 12(a)(2).<sup>143</sup> The Ninth Circuit in *NVIDIA* held that while Item 303 can provide a duty to disclose for other sections of the Act, it does not suffice for Section 10(b).<sup>144</sup> The *NVIDIA* Court noted that “liability arises from an omission in contravention of an affirmative legal disclosure obligation, . . . [but] there is no such requirement under Section 10(b) or Rule 10b-5.”<sup>145</sup> This is a faulty statement. First, while it is true that identical language does not appear in Section 10(b), the section does make it unlawful to “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.”<sup>146</sup> In essence, the statement “in contravention of such rules and regulations as the SEC may prescribe as necessary” equates to the same thing as “in contravention of an affirmative legal disclosure obligation,” particularly in light of the *Glazer*<sup>147</sup> Court which held that a regulation can serve as a duty to disclose which could trigger securities fraud liability.

Section 12(a)(2)’s relevance to Item 303 could translate into Section 10(b), although they do have some differences. Section 12(a)(2), unlike Section 10(b), is applicable to securities exchange rules.<sup>148</sup> A violation of securities exchange rules is truly “inapposite” to Section 10(b).

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<sup>142</sup> 634 F.3d 706, 716 (2d Cir 2011); *see also* *Panther Partners*, 681 F.3d at 120; *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998).

<sup>143</sup> 15 U.S.C. § 771(a)(2) (2015).

<sup>144</sup> *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1055 (9th Cir. 2014), *cert denied*, *Cohen v. NVIDIA Corp.*, 2015 U.S. LEXIS 3522 (U.S., May 26, 2015).

<sup>145</sup> *Id.* at 1055-56 (internal citations omitted).

<sup>146</sup> 15 U.S.C. § 78j(b) (2015) (emphasis added).

<sup>147</sup> *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992).

<sup>148</sup> *See In re Pacific Gateway Exchange, Inc., Sec. Litig.*, No. C-00-1211 PJH, 2002 WL 851066, at 13 (N.D. Cal. Apr. 30, 2002) (holding that stock exchange rules are not duties to disclose under Section 10(b)); *contra*, *Anderson v. Abbott Labs.*, 140 F. Supp. 2d 894, 908 (N.D. Ill. 2001) (SEC rules are informative but not a duty to disclose).

Second, the *Stratte-McClure* court,<sup>149</sup> in quoting *NVIDIA*'s analysis of *Litwin* pointed out that, identical to Section 10(b), Section 12(a)(2) makes it unlawful to omit “material fact[s] . . . necessary in order to make . . . statements, in light of the circumstances under which they were made, not misleading.”<sup>150</sup> The fact that both sections hone in on the same type of material facts means that once Item 303 has been considered a duty to disclose under Section 12(a)(2), it should be equally applicable to Section 10(b).

Finally, in light of Item 303 being “inapposite” to the materiality test of *Basic*, that would merely suggest that Item 303 is not a duty to disclose information for Rule 10b-5. Rule 10b-5 states, in relevant part: “[i]t shall be unlawful for any person . . . to omit to state a material fact necessary in order to make the statements made, . . ., not misleading”<sup>151</sup> The *Basic* probability/magnitude test<sup>152</sup> which defines “material fact,” is specific to Rule 10b-5. However, Section 10(b) makes it unlawful to, “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.*”<sup>153</sup> Section 10(b) makes no mention of a “materiality” requirement in order to attach liability for omissions. It would therefore reason to argue that Item 303, which has a materiality test, could trigger liability under Section 10(b), because an Item 303 omission is “in contravention of such rules and regulations as the [SEC] may prescribe as necessary,” even where it does not meet the probability/magnitude test.

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<sup>149</sup> *Stratte-McClure v. Stanley*, 776 F.3d 94, 104 (2d Cir. 2015).

<sup>150</sup> *Id.* (quoting 15 U.S.C. § 771).

<sup>151</sup> 17 C.F.R. 240.10b-5(b) (2016).

<sup>152</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988).

<sup>153</sup> 15 U.S.C. § 78j(b) (2015) (emphasis added).

*i. Policies Under Which the Securities Exchange Act was Enacted*

Congress enacted the Securities Exchange Act in response to the stock market crash of 1929.<sup>154</sup> “Among Congress’ objectives in passing the 1934 Act was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”<sup>155</sup> Caveat emptor is defined as “the principal that a person who buys something is responsible for making sure that it is in good condition, works properly, etc.”<sup>156</sup> This principal is the antithesis to our capitalistic society in general and to efficient securities markets in particular. Besides protecting the investor, full disclosure requirements heightens the ethical standards of the marketplace.<sup>157</sup> Investors are most protected when the market is efficient, which occurs when all material information is made available to potential buyers and therefore already incorporated into share prices.<sup>158</sup> Upon its creation pursuant to the 1934 Securities Exchange Act,<sup>159</sup> the SEC essentially became the “watchdog of the securities marketplace.” It is therefore a most noteworthy Congressional objective to ensure that companies are appropriately reporting that information considered important by the SEC.

*ii. Floodgate Litigation*

Together with the expansion of possible liability for companies comes the ubiquitous fear of the judicially clogged docket.<sup>160</sup> The expansion of liability can burden an already busy judiciary

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<sup>154</sup> 15 U.S.C. § 77a *et seq* (2015); *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976).

<sup>155</sup> *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 128 (1972) (internal citations omitted).

<sup>156</sup> [www.merriam-webster.com/dictionary/caveat%20emptor](http://www.merriam-webster.com/dictionary/caveat%20emptor) (last visited Dec. 30, 2015).

<sup>157</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976).

<sup>158</sup> *See e.g.*, *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (“the Rule [Rule 10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.”)

<sup>159</sup> *See e.g.*, 1933 Act §§ 8, 19, 20, 15 U.S.C. §§ 77h, 77s, 77t; 1934 Act §§ 9, 19, 21, 15 U.S.C. §§ 78i, 78s, 78u (2015); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-95 (1976)

<sup>160</sup> *See SEC v. Conaway*, 698 F. Supp. 2d 771, 843 n. 58 (E.D.M.I. 2010).

as well as create a potential for frivolous securities litigation that “can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law.”<sup>161</sup> However, some safety nets are available to protect against floodgate litigation. In 1995, Congress enacted the Private Securities Litigation Reform Act<sup>162</sup> (PSLRA) heightening the pleading standard for plaintiff’s claims under Section 10(b). In fact, PSLRA was specifically enacted “as a check against abusive litigation in private securities fraud actions.”<sup>163</sup> Pursuant to PSLRA, plaintiffs must link specific facts to alleged violation and scienter.<sup>164</sup> As a significant burden on plaintiffs, this pleading requirement helps to reduce the amount of frivolous claims possible.

Additionally, by following a “rigorous review of the materiality standard under *Basic, Inc.*, district courts have tools at their disposal to weed out many – albeit not all – baseless claims early in the litigation.”<sup>165</sup> The “materiality standard” of *Basic, Inc.* states that forward-looking information is considered material when it meets the “balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”<sup>166</sup> This test is a “sliding scale”<sup>167</sup> that is entrusting courts with subjective discretion to determine the materiality of information required to be disclosed.

### *iii. Potentially High Burden on Corporations and Individuals*

A broader scope of Section 10(b) including Item 303 duties to disclose threatens to impose large burdens on corporations, both in the courtroom and the conference room. In the conference room, corporations facing broader disclosure requirements may be required to disclose information

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<sup>161</sup> *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007).

<sup>162</sup> 15 U.S.C. § 78u-4 (2015).

<sup>163</sup> *Tellabs*, 551 U.S. at 313.

<sup>164</sup> *See* 15 U.S.C. § 78u-4(b)(2) (2015).

<sup>165</sup> *SEC v. Conaway*, 698 F. Supp. 2d 771, 843 n. 58 (E.D.M.I. 2010).

<sup>166</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988).

<sup>167</sup> *See supra*, notes 92-95 and accompanying text.

threatening their competitive edge in the marketplace. While the prospective of protecting the (potential) investor and increasing honesty in the marketplace are noble objectives, securities fraud liability must not strip corporations of their ability to succeed in a competitive environment.<sup>168</sup> As the District Court for the Southern District of New York said:

*It is inherently absurd to impose on companies in highly competitive, consumer-based industries an affirmative duty to disclose to competitors sensitive pricing and marketing decisions. It would defy reason (and long-established business practices) to interpret a regulation concerned with analyzing ‘operations’ and ‘financial condition’ and furnishing a ‘narrative form of the financial data’ as requiring such disclosure. S-K 303’s mandate to disclose material ‘trends and uncertainties’ does not contemplate furnishing competitors with an analytical blueprint of a company’s business strategies.*<sup>169</sup>

Careful consideration of Item 303 renders the disclosure duty of Item 303 “inapposite” to competitive information. The regulation requires disclosure of “*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>170</sup> This does not, and indeed should not, include competition-sensitive information such as marketing decisions. What it does include, however, is “events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments).”<sup>171</sup> For example, In *In re Caterpillar*,<sup>172</sup> Caterpillar did not disclose its full knowledge of a foreign government’s imminent efforts to restructure its economy which would threaten to reduce the effects of inflation closely tied to Caterpillar’s prior success

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<sup>168</sup> See e.g. Phillip Morris, 75 F.3d at 809; In re Verifone S.E.C. Litig., 784 F. Supp. 1471, 1483 (N.D. Cal. 1992); Ventry v. Sands (In re Canandaigua Sec. Litig.), 944 F. Supp. 1202, 1211 (S.D.N.Y. 1996).

<sup>169</sup> Canandaigua, 944 F. Supp. at 1211 (emphasis added).

<sup>170</sup> 17 C.F.R. 229.303 (2016) (emphasis added).

<sup>171</sup> *Id.*

<sup>172</sup> 1992 SEC LEXIS 786 (1992).

in the country. The Court found that Caterpillar had a duty to disclose this information pursuant to Item 303.<sup>173</sup> This type of information is not considered competition-sensitive that would “furnish[] competitors with an analytical blueprint of a company's business strategies.”<sup>174</sup>

Instruction 3 of Item 303 reads: “The 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>175</sup> In other words, disclosure is required in fact-patterns similar to *Caterpillar* but not information that is competition-sensitive. Similarly, information required to be disclosed under Item 303 in cases like *Oran*,<sup>176</sup> *NVIDIA*<sup>177</sup> which involved a product defect, or *Stratte-McClure*<sup>178</sup> which involved the existence of a losing investment, should not be classified as “competition-sensitive” information. Rather, it should be classified as “events . . . known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition,”<sup>179</sup> which a corporation would not suffer unfair competition subsequent to an appropriate disclosure.

#### *iv. Flood-Gate Disclosure Requirements*

In *Northway*, the Supreme Court has expressed its worry that “broadening disclosure requirements . . . would effectively bury shareholders in an avalanche of trivial

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<sup>173</sup> *Id.* at \*21-22.

<sup>174</sup> Canandaigua, 944 F. Supp. at 1211.

<sup>175</sup> 17 C.F.R. 229.303, instr. 3 (2016).

<sup>176</sup> 226 F. 3d 275 (3d Cir. 2000).

<sup>177</sup> 768 F.3d 1046 (9<sup>th</sup> Cir. 2014), *cert denied* Cohen v. NVIDIA Corp., 2015 U.S. LEXIS 3522 (U.S., May 26, 2015).

<sup>178</sup> 776 F.3d 94 (2d Cir. 2015).

<sup>179</sup> 17 C.F.R. 229.303, instr. 3 (2016).

information – a result that is hardly conducive to informed decision making.”<sup>180</sup> However, this is not particularly significant regarding Item 303. The type of information in *Northway* that threatened to cause an “avalanche” used a different rule, Rule 14a-3, requiring disclosure of information specifying the amount of control that an acquiring company would have over the target company.<sup>181</sup> This is distinct from Item 303, which requires “known trends and uncertainties” that threaten to effect net sales, revenues, or income, focusing specifically on that information which may render information previously disclosed to not reflect the future financial condition. The pigeonhole which Item 303 information fits into is not merely any known information, but that which has a potential to make prior disclosures not indicative of the company’s true financial condition. This requirement is specific enough that would not cause an “avalanche” of information if Item 303’s disclosure requirements is expanded to also meet a duty requirement under Section 10(b).

Additionally, while it is an appropriate concern about “burying shareholders in an avalanche of information,” a cost-benefit analysis of the need-to-disclose and the need-to-omit tips in favor of disclosure. As already mentioned above in detail,<sup>182</sup> this is particularly true considering the compelling policy reasons favoring broad disclosure requirements. Where no liability attaches for omissions – especially those which the SEC required to be disclosed – companies would refrain from making that disclosure. An SEC disclosure duty without the “power of the purse or sword” will be consistently overlooked.

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<sup>180</sup> *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976) (internal citations omitted).

<sup>181</sup> 17 C.F.R. § 240.14a-3 (2016).

<sup>182</sup> *See supra*, notes 154-67 and accompanying text.

## Conclusion

In resolving the circuit split concerning whether Item 303 provides a duty to disclose information is actionable under Section 10(b) and Rule 10b-5, the best answer is to consider Item 303 as a duty to disclose for Section 10(b) and attach liability based on this reasoning. The Circuit Courts, when examining the issue, confuse the issues of *Basic* materiality standard and the threshold duty to disclose required before Section 10(b) elements can be proven. To successfully plead a Section 10(b) claim, the plaintiff must first allege a duty to disclose and then claim the *prima facie* elements of Section 10(b), which include materiality.

Considering that the securities laws were enacted to provide the (potential) shareholder with information allowing for informed decisions and that there is persuasive First and Second Circuit precedent that regulations provide this duty, it therefore stands to reason that Item 303 provides a duty to disclose for Section 10(b). There are other safeguards available, i.e. PLSRA, to shield the courts from floodgate litigation.<sup>183</sup> Additionally, there would not be an undue burden on corporations required to make added disclosures facing liability under Section 10(b). Therefore, in the interests of case law and good policy, Item 303 should per se be considered a duty to disclose for Section 10(b). Where the *prima facie* elements of Section 10(b) have been shown, Item 303 should provide the basis for an appropriately pled Section 10(b) claim.

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<sup>183</sup> See *supra*, note 161 and accompanying text.