REVIVING A RULE 10B-5 PRIVATE ACTION FOR MD&A VIOLATIONS AFTER *MACQUARIE*

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OVERVIEW

- Statutory and Regulatory Background: Item 303, § 10(b), and Rule 10b-5
- Circuit Split on the Connection between Item 303 Disclosure Violations and Rule 10b-5 Private Actions
- *Macquarie v. Moab Partners*: Holding, Rationale, and Ramifications
- Recommendations and Takeaways

STATUTORY AND REGULATORY BACKGROUND

ITEM 303 OF REGULATION S-K: MD&A DISCLOSURES

- Item 303 requires disclosure of "material information relevant to an assessment of the financial condition and results of operations of the registrant" in periodic filings with the SEC. 17 C.F.R. § 229.303.
- Item 303 provides further guidance to management:
  - The discussion and analysis must focus specifically on **material events and uncertainties known to management** that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This includes descriptions and amounts of matters that have had a material impact on reported operations, as well as matters that are **reasonably likely based on management's assessment to have a material impact** on future operations.
- This is notably the only situation where the federal securities laws mandate the disclosure of forward-looking information.

SEC INTERPRETIVE GUIDANCE ON MD&A DISCLOSURES

- According to the SEC, "where a trend, demand, commitment, event or uncertainty is both **presently known** to management and **reasonably likely to have material effects** on the registrant's financial condition or results of operation," a duty to disclose exists under Item 303.
- When such a trend, demand, commitment, or uncertainty is known, management must engage in 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.

IMPORTANCE OF THE MD&A

- According to commentators, "the MD&A has become a major, if not the major, item of narrative disclosure that is studied, together with the financial statements, for investment decisions and analysis purposes." Carl W. Schneider, *MD&A Disclosure*, 22 REV. SEC. & COMMODITIES REG. 149, 150 (1989).
- To many investors, Item 303 is "[o]ften the most important textual disclosure item in Regulation S-K." II LOUIS LOSS ET AL., SECURITIES REGULATION 294 (6th ed. 2019).

SECTION 10(B) AND RULE 10B-5

- Section 10(b) of the Securities Exchange Act was designed with broad applicability as a "catch-all" antifraud provision.
- Rule 10b-5 broadly prohibits, in connection with the purchase or sale of any security, any person, directly or indirectly, to:
  - (a) [] employ any device, scheme, or artifice to defraud,
  - (b) [] make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, or
  - (c) [] engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person[.]

PRIVATE ACTIONS UNDER § 10(B) AND RULE 10B-5

- While a private cause of action for damages under § 10(b) is not expressly mentioned in the statutory text or Rule 10b-5, courts have implied the existence of such a right for decades, with the Supreme Court noting that "the existence of this implied remedy is simply beyond peradventure." *Herman & MacLean v. Huddleston,* 459 U.S. 375, 380 (1983).

PRIVATE ACTIONS UNDER § 10(B) AND RULE 10B-5 – ELEMENTS

1. Requisite jurisdictional means;
2. Plaintiff as purchaser or seller;
3. Manipulative or deceptive practice;
4. Materiality;
5. Defendant's scienter;
6. Plaintiff's reliance;
7. Loss causation;
8. "In connection with" the purchase or sale of a security;
9. Omission liability (where liability is based on silence);
10. Damages.

PRIVATE ACTIONS UNDER § 10(B) AND RULE 10B-5 – ADDITIONAL CONSIDERATIONS

- Section 10(b) private actions are subject to a two-year statute of limitations and a five-year statute of repose, after which time no action can be brought by a private plaintiff.
- Further, § 10(b) claimants must satisfy certain heightened pleading requirements pursuant to the Private Securities Litigation Reform Act (PSLRA), whereby they must plead fraud with particularity and establish a "strong inference" of scienter.

SEC ENFORCEMENT OF MD&A VIOLATIONS

- SEC enforcement of MD&A violations has largely focused on egregious violations.
- In the Matter of Caterpillar Inc., Exchange Act Release No. 34-30532 (Mar. 31, 1992)
  - Dealt with Caterpillar's failure to disclose the impact of Brazilian hyperinflation on its subsidiary, Caterpillar Brasil, S.A., which accounted for twenty-three percent of Caterpillar's 1989 net profits.
- In the Matter of Under Armour Inc., Exchange Act Release No. 34-91741, (May 3, 2021)
  - Stemmed from the company's egregious use of pull-forwards to inflate its annual revenues.

CIRCUIT SPLIT ON ITEM 303'S CONNECTION TO § 10(B) AND RULE10B-5

VERIFONE (9TH CIR.)

- Held that Item 303 did not create a duty to disclose a number of negative outlooks on future growth.
  - Even when these trends were presently known to management at the time of VeriFone's IPO and VeriFone's stock price fell by more than seventy percent after its initial offering.
- The *VeriFone* court's holding implied that there could be no private § 10(b) and Rule 10b-5 cause of action for MD&A violations in that circuit, since without a duty to disclose, silence cannot sustain a private § 10(b) claim.
- After *Verifone*, the circuit cases which considered Item 303's connection to § 10(b) and Rule 10b-5 focused largely on:
  - (1) whether Item 303 created a duty to disclose for purposes of a § 10(b) and Rule 10b-5 private action;
  - (2) the compatibility of Item 303's materiality standard with private claims under § 10(b) and Rule 10b-5.

ORAN (3D CIR.)

- Factual Background
  - The dispute in Oran centered on the failure of American Home Products (AHP) to disclose heart valve and other cardiac problems revealed by clinical studies of two weight-loss drugs, Pondimin and Redux.
  - However, once this information was made public and AHP took appropriate remedial action, the reaction of the capital markets was minimal.
- Procedural History
  - Plaintiffs alleged that AHP's failure to disclose this information for over three years was a violation of (among other things) Item 303's MD&A requirements, and sued under §§ 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5.
  - District court dismissed.

ORAN (3D CIR.)

- Issues and Holdings
  - (1) whether there was an independent private right of action under Item 303 (a question left open from prior cases in that circuit);
    - Held: No.
  - (2) whether Item 303 created a duty to disclose for purposes of a private § 10(b) action;
    - Held: No.
  - (3) whether a violation of Item 303's MD&A requirements could support a private claim under § 10(b).
    - Left open for future consideration.

ORAN (3D CIR.)

- Duty to Disclose and Focus on Materiality:
  - The Third Circuit reasoned that because Item 303's materiality test "varies considerably from the general test for securities fraud materiality set out by the Supreme Court in *Basic Inc. v. Levinson*," disclosure deficiencies in the MD&A did not satisfy the requirement of a duty to disclose in a § 10(b) private action.
  - In support of this holding, the Oran court cited the SEC's 1989 concept release on the MD&A, which advised that "[t]he probability/magnitude test for materiality approved by the Supreme Court in *Basic* . . . is inapposite to Item 303 disclosure."
    - Notably, the SEC's 1989 concept release on MD&A, cited in Oran, only stated that Basic's test was inapposite to *disclosure* under Item 303. It did not deny the existence of a duty to disclose for purposes of Rule 10b-5 liability.
    - From the SEC's language, it should be apparent that if *more* information is material for Item 303 disclosure, then *some* of that information will be material under § 10(b).

ORAN (3D CIR.)

- Ultimately, the *Oran* court left open the 10b-5 route for violations of Item 303's disclosure requirements if a separate duty to disclose was adequately alleged.
  - "[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[.]"
- "[A] violation of [Item 303]'s reporting requirements does not *automatically* give rise to a material omission under Rule 10b-5."
  - Differing interpretations of this statement contributed significantly to division among the circuits.

IN RE NVIDIA (9TH CIR.)

- Factual Background:
  - NVIDIA became aware of a problem with weak solder points in its graphics processing unit (GPU) and media and communication processor (MCP) chips, but did not disclose this information to the public for nearly two years—omitting the issue from its periodic reports in the meantime.
  - When the issue with NVIDIA's weak solders was released in a 2008 Form 8-K, NVIDIA's leadership estimated that the total loss would be in the range of $150–200 million.
  - The market reaction to this disclosure was quick and significant, and NVIDIA's market capitalization declined by over $3 billion—a corrective reaction of thirty-one percent.
  - Shareholders brought suit under § 10(b) and Rule 10b-5 for NVIDIA's failure to disclose the solder problem in its MD&A once it became known to management.

IN RE NVIDIA (9TH CIR.)

- Reasoning and Holding:
  - The *NVIDIA* court relied heavily on language from *Oran* that a violation of Item 303's disclosure mandate did not "lead inevitably" to a conclusion that such disclosure would be required under Rule 10b-5.
  - Held: Item 303 did not create a duty to disclose for purposes of § 10(b) and Rule 10b-5, and that private § 10(b) plaintiffs must demonstrate defendant's violation of "a duty to disclose . . . according to the principles set forth by the Supreme Court in *Basic* and *Matrixx Initiatives*" in order to establish a claim.

STRATTE-MCCLURE (2D CIR.)

- Factual Background
  - Morgan Stanley took two positions in the subprime mortgage market as of late 2006:
    - A $2 billion short position on Credit Default Swaps on debt backed by subprime mortgage-backed securities (asset-backed securities or ABS); and
    - A $13.5 billion long position to sell higher-rated CDOs.
  - This position reflected, to simplify, a bet that the subprime mortgage market would go bust, but that the lower-risk CDOs would not be impaired by the crash.
  - Ultimately, the firm underestimated the impact of the subprime mortgage crash on the market at large, and by Q3 2007 the long position had lost $4.4 billion.
  - Neither the long position nor the losses stemming therefrom were disclosed in Morgan Stanley's periodic reports during the class period.
- Plaintiffs brought a securities fraud class action against Morgan Stanley and certain of its officers and former agents, and alleged among other claims that Morgan Stanley's failure to disclose its exposure to and losses from its positions in the subprime mortgage market violated Item 303's MD&A disclosure mandate and was actionable under § 10(b) and Rule 10b-5.

STRATTE-MCCLURE (2D CIR.)

- Holding and Rationale
  - "We note that our conclusion is at odds with the Ninth Circuit's recent opinion in [*NVIDIA*]."
  - "Contrary to the Ninth Circuit's implication that *Oran* ***compels*** a conclusion that Item 303 violations are never actionable under 10b-5, *Oran* actually suggested, without deciding, that in certain instances a violation of Item 303 could give rise to a material 10b-5 omission." (emphasis in original).
  - Therefore, the Second Circuit held that "a failure to make a required disclosure under Item 303 of Regulation S-K, 17 C.F.R. § 229.303(a)(3)(ii), in a 10-Q filing is an omission that can serve as the basis for a § 10(b) securities fraud claim, if the omission satisfies the materiality requirements outlined in *Basic* . . ." and provided that "all of the other requirements to sustain an action under § 10(b) are fulfilled."

CARVELLI (11TH CIR.)

- Background
  - investors filed a putative securities fraud class action against Ocwen Financial, a corporation which handled mortgage services and foreclosures, alleging among other claims that Ocwen's failure to disclose systemic failures regarding its loan servicing program amounted to a violation of Item 303's disclosure mandate which was actionable under § 10(b).
  - As a result of regulatory action arising from problems with Ocwen's loan servicing program, Ocwen's stock price fell by 53.9 percent.
- In an issue of first impression in the Eleventh Circuit, the *Carvelli* court relied heavily on the *Oran* and *NVIDIA* courts' rationales to hold that Item 303 does not create an actionable duty to disclose for purposes of a § 10(b) and Rule 10b-5 private action.

MACQUARIE INFRASTRUCTURE CORP. V. MOAB PARTNERS, L.P.

BACKGROUND & PROCEDURAL HISTORY

- Defendant Macquarie is a publicly-traded holding company, incorporated in Delaware, which owns and operates infrastructure-related enterprises.
- One of Macquarie's highest-performing subsidiaries was engaged in the storage and sale of No. 6 fuel.
  - In 2016, the International Maritime Organization promulgated IMO 2020, which restricted the use of No. 6 fuel.
  - Macquarie declined to disclose the potential impacts of IMO 2020 when it was initially promulgated in 2016, nor was it disclosed for approximately two years thereafter.
- When the impact of IMO 2020 on Macquarie's subsidiary was disclosed in a 2018 earnings call, Macquarie's share price fell approximately forty-one percent.

BACKGROUND & PROCEDURAL HISTORY

- Shareholders sued, alleging violations of various antifraud provisions of the federal securities laws because of Macquarie failure to disclose the potential impacts of IMO 2020, in violation of Item 303's disclosure mandate.
- The Southern District of New York initially dismissed plaintiffs' claims, but on appeal, the Second Circuit reversed, holding that Macquarie's Item 303 violations could support certain of plaintiffs' § 10(b) claims.
  - "[A]s pleaded, it would not have been 'objectively reasonable' for Defendants to determine that IMO 2020 would not likely have a material effect on [Macquarie]'s financial condition or operations."

THE SUPREME COURT'S NARROW ISSUE AND QUESTIONS AT ORAL ARGUMENT

- The Supreme Court granted certiorari to address the narrow issue of "whether the failure to disclose information required by Item 303 can support a private action under Rule 10b-5(b), even if the failure does not render any 'statements made' misleading."
- While much of the dispute at the circuit court level had centered around whether Item 303 created a duty to disclose and the compatibility of Item 303's broader materiality standard with the standard of materiality in a § 10(b) claim, materiality and duty were far from the focus at oral argument (or in the Court's opinion).

THE SUPREME COURT'S NARROW ISSUE AND QUESTIONS AT ORAL ARGUMENT

- At oral argument, much of the contention before the Court was over textual analysis of Rule 10b-5(b)'s scope and whether it captured "pure" omissions or whether an affirmative statement must be alleged that was rendered misleading.
  - Justice Jackson was the first to bring up the distinction in language between § 11 of the Securities Act and Rule 10b-5(b), noting that the former includes the phrase "required to be stated therein" before its additional language regarding omissions which make a statement misleading.
- The Court was also wary of any construction of § 10(b) which could be seen as an expansion of the judicially created private right of action under that statute.

HOLDING AND RATIONALE

- Held: pure omissions are not actionable under Rule 10b-5(b).
- Pure omissions vs. half-truths
  - "A pure omission occurs when a speaker says nothing, in circumstances that do not give any particular meaning to that silence. Take the simplest example. If a company fails entirely to file an MD&A, then the omission of particular information required in the MD&A has no special significance because no information was disclosed."
  - A half-truth, by contrast, is a "representation[] that state[s] the truth only so far as it goes, while omitting critical qualifying information."

HOLDING AND RATIONALE

- The Court was careful to limit the reach of its holding in footnote 2 to the opinion:
  - "The Court does not opine on issues that are either tangential to the question presented or were not passed upon below, including what constitutes 'statements made,' when a statement is misleading as a half-truth, or whether Rules 10b-5(a) and 10b-5(c) support liability for pure omissions."

PROBLEMS WITH *MACQUARIE'S* RATIONALE

1. Scope and applicability of § 10(b)
2. Textual analysis of "statements made" language in Rule 10b-5(b)
3. Comparison of Rule 10b-5 with § 11 of the Securities Act
4. Use (and nonuse) of applicable precedent

MISCONSTRUCTION OF § 10(B)'S SCOPE

- "Rule 10b-5 . . . makes it unlawful for issuers of registered securities 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, in the light of the circumstances under which they were made, not misleading.'" *Macquarie*, 601 U.S. at 260.
  - Read literally, this limits the scope of Rule 10b-5 to only those securities that are registered, and imposes liability only upon the issuers of those securities.
- This pronouncement is fundamentally inconsistent with prior Supreme Court jurisprudence on the § 10(b) private right of action, the underlying intent of § 10(b) and Rule 10b-5, and the plain text of the rule itself.
  - 15 U.S.C. § 78j (prohibiting "any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance"); 17 C.F.R. § 240.10b-5 (applying to "the purchase or sale of any security"); *see also Huddleston*, 459 U.S. at 382; Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce, 73d Cong. 115 (1934).

INCONSISTENT LINGUISTIC ANALYSIS

- Later in its analysis, the court considers plain language definitions of "statement," from the relevant editions of the Oxford English Dictionary and Webster's New International Dictionary, positing that these definitions support its holding.
  - 6 OXFORD ENGLISH DICTIONARY 857 (1933) (def. 3) (defining "statement" as a "written or oral communication setting forth facts, arguments, demands, or the like")
  - WEBSTER'S NEW INTERNATIONAL DICTIONARY 2461 (2d ed. 1942) (defining "statement" as the "[a]ct of stating, reciting, or presenting, orally or on paper")
- But neither of these definitions speaks in any way to the requisite length or specificity of a "statement."
- Indeed, on the very definitions provided by the court, the government's argument in the alternative that the applicable statement in this case is the MD&A itself still holds.

RULE 10B-5 COMPARED TO SECTION 11

- Even the textual discrepancy between § 11 and Rule 10b-5(b)'s omissions language—arguably the most convincing rationale for the Court's holding due to application of the Canon Against Surplusage—is not without significant flaws.
- These provisions stem from different statutes and are not analogs of each other.
  - Section 11 pertains only to deficiencies in registration statements, where certain information is "required to be stated" pursuant to applicable law and regulation. Its focus on disclosure alone is clear, since it is a strict liability provision.
  - By contrast, § 10(b) and Rule 10b-5 were enacted to cover a wide range of securities transactions, where there may not be specific informational requirements (but, as in the case of the MD&A, there often are).

RULE 10B-5 COMPARED TO SECTION 11

- Rule 10b-5's focus on fraudulent conduct is further clarified by the inclusion of certain necessary elements in its cause of action, such as scienter and reliance—it is clearly not a strict liability provision focused solely on disclosure.
- As such, holding that Rule 10b-5 captures pure omissions would not have rendered § 11's language superfluous, since there are significant contextual differences between the two provisions. Nor would it have unduly shifted Rule 10b-5's focus from fraud to disclosure.

MISUSE OF APPLICABLE PRECEDENT

- As a final note on the focus of § 10(b) and Rule 10b-5, the *Macquarie* court makes repeated reference to the statement in *Chiarella* that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."
  - But the Court neglects to include in its reasoning the very next sentence of the *Chiarella* opinion, which expressly states that a securities fraud claim under § 10(b) can be premised on nondisclosure: "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."
  - *Chiarella*, 445 U.S. at 235; *see also Zandford*, 535 U.S. at 819 (reasoning that § 10(b) must not be construed "technically and restrictively, but flexibly to effectuate its remedial purposes")

IMPLICATIONS – MISINTERPRETATION

- One federal appellate court has already misconstrued Macquarie to foreclose claims for pure omissions under any subsection of Rule 10b-5 — something that the Supreme Court was very careful to avoid saying in its holding.
  - *Appvion, Inc. Ret. Sav. & Employee Stock Ownership Plan by & through Lyon v. Buth*, 99 F.4th 928 (7th Cir. 2024); *Alcarez v. Akorn, Inc.*, 99 F.4th 368, 373 (7th Cir. 2024) ("nondisclosure does not violate Rule 10b-5") (citing *Macquarie*, 601 U.S. 257).
  - In *Appvion*, the Seventh Circuit dismissed plaintiff's securities fraud claims under Rule 10b-5 for misleading information contained in defendant's periodic reports, which allegedly misrepresented Appvion, Inc.'s value. In support of its holding, the court misconstrued Macquarie as standing for the proposition that "pure omissions are insufficient to show a violation of SEC Rule 10b-5, which prohibits fraud." *Appvion*, 99 F.4th at 942; *but see Macquarie*, 601 U.S. at 266 n.2 (declining to rule on whether pure omissions are actionable under Rule 10b-5(a) or (c) and clarifying that the Court's holding was limited only to Rule 10b-5(b)).

IMPLICATIONS – ENFORCEMENT

- Shifting the onus of enforcement for pure omissions entirely to the SEC will almost certainly result in a greater number of violators slipping through the cracks, and will likely have a chilling effect on the amount of information disclosed in the MD&A, since Exchange Act reporting companies can now avoid private liability under 10b-5(b) for MD&A violations by simply refusing to speak to an issue (even in the face of an SEC disclosure mandate).
- Notably, other avenues remain, such as Rules 10b-5(a) and (c), which address omission and scheme liability. 17 C.F.R § 240.10b-5(a), (c). Further, the SEC retains the ability to enforce violations of the reporting obligations of § 13 of the Exchange Act, as well as § 17(a)(2) of the Securities Act—and negligence is a sufficient mental state for culpability under these provisions, rather than § 10(b)'s scienter standard. See generally 15 U.S.C. § 78m; 15 U.S.C. § 77q.
  - However, because Rule 10b-5 actions allow for greater penalties, they are likely a more effective deterrent to violators.

TAKEAWAYS & RECOMMENDATIONS

NEXT STEPS AND CONSIDERATIONS IN THE WAKE OF *MACQUARIE*

1. Scheme liability precedent likely captures pure omissions of the sort proscribed by the *Macquarie* Court.
2. Item 303 should be modified to include language for actionable omissions.
3. Item 303's materiality standard should be revised to comport with the prevailing standard under the securities laws.
4. Already-existing safeguards for forward-looking information disclosed in the MD&A ensure that these recommendations produce a balanced result.

SCHEME LIABILITY PRECEDENT CAPTURES PURE OMISSIONS

- Unlike Rule 10b-5(b), subsections (a) and (c) of the Rule broadly prohibit any person "[t]o employ any device, scheme, or artifice to defraud" or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."
  - These prohibitions are not accompanied by "statements made" qualifiers, and as such can capture pure omissions in addition to affirmative misstatements —even under Macquarie's rationale.

SCHEME LIABILITY PRECEDENT CAPTURES PURE OMISSIONS

- Generally, a "Scheme" under Rule 10b-5 is "'a plan or program of something to be done; an enterprise; a project; as, a business scheme, or a crafty, unethical project.'"
  - *S.E.C. v. Familant*, 910 F. Supp. 2d 83, 94 (D.D.C. 2012) (*quoting SEC v. Aaron*, 446 U.S. at 696 n.13 (1980) (citing WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)) (cleaned up)
- The scheme liability subsections of Rule 10b-5, as one court notes, proscribe "activities designed to affect the price of a security artificially by simulating market activity that does not reflect genuine investor demand."
  - *Desai v. Deutsche Bank Securities Ltd.*, 573 F.3d 931, 940–941 (9th Cir. 2009)
- The focus of the inquiry in a private claim alleging a scheme to defraud is on the conduct of the defendants, rather than specific deceptive statements. As such, provided that defendants engaged in a scheme to omit material information from an item of narrative disclosure like the MD&A, private plaintiffs may bring suit under Rule 10b-5(a) and (c).

SCHEME LIABILITY PRECEDENT CAPTURES PURE OMISSIONS

- The Supreme Court's scheme liability precedent strongly supports this approach.
- *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).
  - Supreme Court found liability under a fiduciary duty theory for violations of subsections (a) and (c) where bank representatives defrauded a group of Native Americans and their representatives by failing to disclose that the bank and its employees would gain financially from the transaction, since the subject shares were selling for a higher price on the non-Indian market.
  - In holding that defendants were liable under Rule 10b-5(a) and (c), the Court reasoned that because defendants "devised a plan and induced" the shareholders to sell "without disclosing to them material facts" that could have impacted that decision, the defendants had engaged in a scheme to defraud.
  - And while the appellate court below had reasoned that Rule 10b-5 did not apply because there were no affirmative misstatements of fact in the record, the Supreme Court correctly reversed, noting that restrictive constructions of Rule 10b-5 are inappropriate.
  - In its rationale, the Affiliated Ute Court further stated that it was "no answer to urge that, as to some of the petitioners, these defendants may have made no positive representation or recommendation." It is clear on this holding that pure omissions of material information can form the basis of a scheme liability claim.

SCHEME LIABILITY PRECEDENT CAPTURES PURE OMISSIONS

- *SEC v. Zandford*, 535 U.S. 813.
  - Supreme Court found a securities broker liable under subsections (a) and (c) of Rule 10b-5 for misappropriating the proceeds of sales in his customers' investment account.
  - The court reasoned that liability was appropriate because "[r]espondent was only able to carry out his fraudulent scheme without making an affirmative misrepresentation" due to a preexisting relationship of trust and confidence with his clients.
  - In the context of a broker-client relationship where there is a discretionary account, which implicates fiduciary duties of care and loyalty due to the broker's control of investment decisions, fraud of omission may represent "an even greater threat to investor confidence in the securities industry" than an affirmative misstatement.
  - In its holding, the *Zandford* Court further emphasized that "any distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients."

SCHEME LIABILITY PRECEDENT CAPTURES PURE OMISSIONS

- Similarly to the broker-dealer context in the case of discretionary accounts, the management of an Exchange Act reporting company owes fiduciary duties of care and loyalty to their shareholders.
- Under *Zandford*, for purposes of scheme liability under Rule 10b-5(a) and (c), any distinction between omissions and misrepresentations is therefore also illusory.
- Both the plain text of Rule 10b-5's scheme liability provisions and applicable Supreme Court precedent clearly convey that MD&A disclosure deficiencies that stem from a scheme to defraud are actionable by private plaintiffs.

ITEM 303 SHOULD BE MODIFIED TO INCLUDE LANGUAGE FOR ACTIONABLE OMISSIONS

- While the existing framework of Rule 10b-5's scheme liability provisions may be sufficient to remedy the ails of private plaintiffs in the wake of *Macquarie*, further action by the Commission is necessary to ensure that investors are properly insulated from the possibility of future restriction.
- First, Item 303's language should be modified to include language for actionable omissions. Sample language for the amended regulation follows:

Sample Language:

The omission of any item required to be stated herein will make the MD&A materially misleading to a reasonable investor, and shall be a violation of Regulation S-K. This violation shall be actionable under the requisite sections of the Securities Exchange Act, including without limitation §§ 10(b) and 20(a) thereof.

ITEM 303 SHOULD BE MODIFIED TO INCLUDE LANGUAGE FOR ACTIONABLE OMISSIONS

- The inclusion of this language into Item 303 is within the SEC's congressionally sanctioned rulemaking authority, as it is both in the public interest and necessary for investor protection.
  - *See* 15 U.S.C. § 78j (enabling promulgation of "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors"); 15 U.S.C. § 78t (providing for liability for persons who control any party that violates "any provision of [the Exchange Act] or [] any rule or regulation thereunder").
- And while including a liability provision within Item 303 would be unique among the narrative disclosure obligations of Regulation S-K, this is justified because Item 303's disclosure mandate for specific forward-looking information is already unique among the securities laws as a whole.

ITEM 303'S MATERIALITY STANDARD SHOULD BE HARMONIZED WITH § 10(B)'S

- *Macquarie* and the circuit split on Item 303 which preceded it makes clear that Item 303's materiality standard must be revisited and revised.
  - The SEC's 1989 release is largely to blame for the circuit split described above, and its looser standard for materiality in the context of Item 303's disclosure mandate is notoriously difficult to apply—for Exchange Act reporting companies preparing their disclosures, for investors reading those disclosures, and for courts analyzing potential violations of those disclosures.
- Accordingly, Item 303's materiality standard must be made consistent with the prevailing definition of materiality as articulated in *Basic*. The time is ripe for an SEC release to set the record straight. Sample language follows:

Sample Language:

If any information described in Item 303 is reasonably likely to be important to a reasonable investor, or reasonably likely to alter the "total mix" of information, then it is material for the purposes of this Regulation and must be disclosed. For the avoidance of doubt, parties shall apply the materiality standard articulated in U.S. Supreme Court decisions to evaluate whether any information required to be stated pursuant to this Item 303 is material and thereby required to be disclosed.

ITEM 303'S MATERIALITY STANDARD SHOULD BE HARMONIZED WITH § 10(B)'S

- Harmonization of Item 303's materiality standard would accomplish several important objectives:
  - It would clarify to reporting companies that "material" means "material," and thereby reporting companies would have consistent standards that would enable easier compliance with Item 303's mandate.
  - While heightened materiality for Item 303 disclosure would likely result in fewer trends or uncertainties being disclosed to the SEC and to the markets, this could be a significant positive change which enhances the efficiency the capital markets.
    - The MD&A is often prohibitively long and resultingly inaccessible to ordinary retail investors.
    - Shortening the MD&A would at once reduce the burdens of compliance for reporting companies while increasing the digestibility of disclosures for investors.
    - And it would increase commercial certainty, because both reporting companies and their investors would know that every disclosure contained in the MD&A was material and could be actionable. By reducing power and information asymmetries between parties, this would result in a more efficient market overall.

ITEM 303'S MATERIALITY STANDARD SHOULD BE HARMONIZED WITH § 10(B)'S

- Modification of Item 303's materiality standard would also be consistent with other disclosure provisions contained in Regulation S-K.
  - For example, in the Commission's release adopting amendments to Item 105's risk factor disclosure mandate, the SEC intentionally changed the standard for risk factor disclosures from the "most significant" factors to "material" risk factors, and clearly stated that the materiality standard to be utilized for the purposes of Item 105 was the prevailing test under *Basic*.
- Because Regulation S-K (including Item 303) is frequently amended in the regular course, this avenue would realistically and practicably remedy many of *Macquarie*'s errors.

FORWARD-LOOKING INFORMATION IN THE MD&A IS SUBJECT TO SAFE HARBORS

- Because of the balanced disclosure and liability frameworks which exist under the securities laws, the Supreme Court's characterization of the inclusion of pure omissions within the ambit of Rule 10b-5(b) as an expansion of the § 10(b) private right of action is inaccurate, and concerns about overbroad applicability are allayed.
- Any disclosure made in the MD&A is subject to the safe harbors for forward-looking statements contained in Rule 175, Rule 3b-6 and the PSLRA.
  - Rule 175 and Rule 3b-6 protect forward-looking statements from securities fraud claims when such statements are disclosed with a reasonable basis or in good faith.
  - And while Rule 175's applicability is limited to specified definitions of "forward-looking statement," among these is "[a] statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K."
  - The PSLRA protects forward-looking information that is immaterial, disclosed with meaningful cautionary language, or where plaintiff cannot prove that defendant had actual knowledge of the falsity of the forward-looking information.
- Any private claims alleging misleading statements or omissions in the MD&A would be subject to the PSLRA's heightened pleading requirements. As a result, fraud must be pleaded with particularity and a strong inference of scienter must be established by any plaintiff who wishes to have success on the merits of their claim.

"[A] § 10(B) ACTION CAN BE BROUGHT BY A PURCHASER OR SELLER OF '***ANY*** SECURITY' AGAINST '***ANY*** PERSON' WHO HAS USED '***ANY*** MANIPULATIVE OR DECEPTIVE DEVICE OR CONTRIVANCE' IN CONNECTION WITH THE PURCHASE OR SALE OF A SECURITY."

Huddleston, 459 U.S. at 382 (emphasis in original) (quoting § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b)).

QUESTIONS?

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