Debevoise & Plimpton

October 2023
Special Issue

INSIDER TRADING & DISCLOSURE UPDATE

Supreme Court to Decide Whether a Private Right of Action Exists for Deficient MD&A

Introduction

The Supreme Court has agreed to hear an appeal relating to whether there is a private right of action for omissions from the disclosures required by Item 303 of Regulation S-K (i.e., Management's Discussion and Analysis of Financial Condition and Results of Operations, or "MD&A"). The Supreme Court was asked to address "[w]hether the Second Circuit erred in holding—in conflict with the Third, Ninth, and Eleventh Circuits—that a failure to make a disclosure required under Item 303 can support a private claim under [Exchange Act] Section 10(b), even in the absence of an otherwise misleading statement."[1] A decision to allow MD&A line-item omissions to serve as a basis for Section 10(b) liability could have a significant impact on private securities fraud litigation.

Background: Macquarie Infrastructure Corp. v. Moab Partners

According to the investor-plaintiffs who initially brought the underlying case, Macquarie Infrastructure Corporation ("MIC")—a publicly traded global financial group that owns and operates a portfolio of infrastructure-related businesses—failed to sufficiently disclose the impact of prospective international maritime regulations on No. 6 oil, which was handled and stored in bulk by an affiliate of MIC, International-Matex Tank Terminals ("IMTT"). In 2008, the International Maritime Organization ("IMO")—a United Nations agency that regulates global shipping—released "IMO 2020," a proposed regulation that would cap the sulfur content of fuel oil used in shipping at 0.5% by 2020, and was predicted to almost entirely eliminate the demand for No. 6 oil, which has a sulfur content of approximately 3%. IMTT experienced a sudden decline in demand for storage of No. 6 oil at its facilities in late 2017 and early 2018. Plaintiffs alleged that, between February 2016 and February 2018, MIC and its management violated Item 303 by failing to predict and disclose that IMO 2020 would have a material negative impact on MIC's overall financial performance.[2] Specifically, plaintiffs alleged that MIC "downplayed its exposure to fluctuations in the use of petroleum products, assuring investors that IMTT had 'no commodity exposure directly' because it 'simply provides access to storage capacity.'"[3] In addition to claiming that MIC and its management violated Item 303, plaintiffs also alleged that the company's disclosure failures violated Exchange Act Section 10(b) and Rule 10b-5 thereunder.[4] MIC has acknowledged that it was required to make such disclosures in MD&A as a "trend or uncertainty that could harm the financial outlook of the company," but argued that a failure to disclose information required by Item 303, alone, could not serve as the basis for private fraud litigation under Section 10(b). The Second Circuit allowed the investor lawsuit against MIC to proceed based on this failure to comply with Item 303. MIC appealed, requesting that the Supreme Court clarify that Section 10(b) liability "arises only where a company makes a statement that is untrue or misleading without further disclosure—not when the company allegedly fails to make all disclosures required by SEC rules."[5]

Item 303 of Regulation S-K and Rule 10b-5

MD&A is a required section of a company's regular financial reporting in which management must discuss the company's historical financial performance and future operations. MD&A is intended to provide investors insight into the company's financial condition and results of operations. Among other things, Item 303 of SEC Regulation S-K requires issuers to disclose "any known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact" on its financial performance.[6]

Item 303 does not explicitly provide a private right of action for investors to sue if these disclosure requirements are not met—it only serves as the basis for an SEC enforcement action. However, private investors are able to sue issuers for material misstatements or omissions in their disclosures under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which makes it unlawful for an issuer to make an untrue statement or omit a material fact "necessary" to make an affirmative statement "not misleading."[7] However, the federal courts are currently split on whether Item 303 creates an affirmative duty of disclosure that is sufficient to establish liability under Section 10(b) and Rule 10b-5.

The Circuit Split

On October 2, 2014, the Ninth Circuit in *In re NVIDIA Corporation Securities Litigation* held that a violation of Item 303 of Regulation S-K was not actionable by private litigants under Section 10(b) of the Exchange Act.[8] NVIDIA is a publicly traded semiconductor manufacturer that, in the spring of 2008, disclosed two product defects leading to a $150-200 million charge to cover costs arising from the defects.[9] A class of investors later claimed that NVIDIA was aware of the product defects and their potential effect on the company's financials in 2007. The class argued that the company's failure to disclose information regarding the defects' impact on future financial performance violated Item 303 and constituted a material omission actionable under Section 10(b) and Rule 10b-5.[10]

The Ninth Circuit, affirming the lower court's decision, found that Item 303 does not create a duty to disclose under Section 10(b), and that Section 10(b) liability "must be separately shown" pursuant to the established 10(b) requirements.[11] The court concluded that the "materiality standards for Rule 10b-5 and Item 303 differ significantly [and that, as a result,] 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.'"[12] The court also explained that the plain text of Section 10(b) differs significantly from that of other provisions of the federal securities laws that do allow for a private action based solely on an Item 303 violation—namely, Sections 11 and 12(a)(2) of the Securities Act, which address misstatements or omissions in registration statements and prospectuses.[13] Unlike Exchange Act Section 10(b), Securities Act Sections 11 and 12(a)(2) explicitly state that liability thereunder may arise from an omission of "a material fact required to be stated."[14] The Ninth Circuit noted that there is no such language under Section 10(b) or Rule 10b-5, which instead address omissions that are "necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."[15] The Eleventh Circuit later agreed with the Ninth Circuit's reasoning, holding in *Carvelli v. Ocwen*[16] that the disclosure obligations imposed by Item 303 and Section 10(b) differ significantly.[17]

Just a few months after the *NVIDIA* ruling, on January 12, 2015, the Second Circuit in *Stratte-McClure v. Morgan Stanley* split from the Ninth Circuit, finding that a violation of Item 303 would be actionable under Section 10(b) and Rule 10b-5 if plaintiffs met the materiality requirements set forth in *Basic Inc. v. Levinson*.[18] In *Stratte-McClure*, a class made up of Morgan Stanley investors brought suit against the bank for alleged material misstatements and omissions related to Morgan Stanley's trading position and exposure to losses in the subprime mortgage market.[19] The Second Circuit reasoned that courts "have long recognized that a duty to disclose under Section 10(b) can derive from statutes or regulations that obligate a

party to speak[,]" and that a "reasonable investor would interpret the absence of an Item 303 disclosure to imply the non-existence of 'known trends or uncertainties[.]'"[20] The court found that Morgan Stanley failed to meet its disclosure obligations under Item 303 and that the bank's omissions were material, but the court ultimately did not find Morgan Stanley liable under Section 10(b) because the plaintiffs had failed to establish a strong inference of scienter.[21]

In 2017, the Supreme Court had the opportunity to address this circuit split in *Leidos, Inc. v. Indiana Public Retirement System*—another class action out of the Second Circuit—but the class ultimately settled before the Court could hear the case.[22] However, prior to the settlement, the Department of Justice ("DOJ") and the SEC filed an amicus brief setting forth the government's position that an Item 303 omission can in fact give rise to Section 10(b) liability, assuming the other elements of a Section 10(b) violation are met.[23] The government reasoned that an Item 303 omission in MD&A disclosures constitutes a "misleading half-truth" and that where an entity is under a duty to disclose, such as with Item 303, "silence can be misleading because a reasonable investor will be aware of the duty and will reasonably infer from a regulated party's silence that no circumstance for which disclosure is required is actually present."[24] The government argued that any Supreme Court decision to the contrary could harm investors by letting issuers off the hook for violations of Item 303—violations that could "dupe investors into believing that the security was less risky than it actually was" and lead to "disparate treatment of materially equivalent conduct" by issuers.[25]

Impact and Takeaways

Six years after the *Leidos* settlement, *Macquarie* presents the Supreme Court with another opportunity to resolve the circuit split. The Supreme Court's decision could have a significant impact on private securities fraud litigation, should Item 303 omissions be allowed to serve as a basis for Section 10(b) liability. This change would enable plaintiffs to establish a duty to disclose when they otherwise may not be able to plead an omission case, potentially expanding Rule 10b-5 liability to more closely resemble Section 11 and 12(a)(2) liability for omissions of "a material fact required to be stated."

Although expanding the private cause of action under Section 10(b) and Rule 10b-5 in this way could incentivize issuers to over-disclose in an effort to prevent costly shareholder suits, issuers are already subject to SEC review and enforcement action regarding omissions in MD&A, so the practical impact of the Supreme Court's decision on issuer activity may be negligible. However, if the Court determines that Item 303 violations can serve as a basis for Rule 10b-5 liability, the ruling may raise questions about whether other disclosure obligations under Regulation S-K should be afforded similar treatment. In light of the upcoming changes to Regulation S-K, including significant new requirements related to cybersecurity risk management and climate change disclosures, the Court's decision in *Macquarie* could have broader implications for issuer liability.

Notes

1 Petition for Writ of Certiorari at i, *Macquarie Infrastructure Corp. v. Moab Partners*, No. 22-1165 (May 30, 2023).
2 *Id.* at 8-9.
3 Plaintiff's Complaint at 3, *City of Riviera Beach Gen. Employees Retirement Sys. v. Macquarie Infrastructure Corp.*, No. 18-cv-03608 (S.D.N.Y. Apr. 23, 2018).
4 *Id.* at 20-21.
5 Petition for Writ of Certiorari, *supra* note 1, at 13.
6 17 CFR § 229.303(b)(2)(ii).
7 17 CFR § 240.10b-5(b).
8 *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014).
9 *Id*. at 1048.
10 *Id.*
11 *Id*. at 1055 (citing *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000)).
12 *Id.*
13 *Id* at 1055-56.
14 15 U.S.C. §§ 77k(a), 77l(b).
15 17 CFR § 240.10b-5(b).
16 934 F.3d 1307 (11th Cir. 2019).
17 *Id.* at 1331.
18 *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015) (citing *Basic Inc. v. Levinson*, 485 U.S. 224 (1988)).
19 *Stratte-McClure*, 776 F.3d at 96.
20 *Id.* at 102 (citing 17 C.F.R. § 229.303(a)(3)(ii)).
21 *Id.* at 105-06.
22 *See* Petition for Writ of Certiorari, *supra* note 1, at 1.
23 Brief for the United States as Amici Curiae Supporting Respondents, Petition for Writ of Certiorari, *Leidos, Inc. v. Indiana Public Retirement Sys*., No. 16-581 (Sept. 7, 2017).
24 *Id.* at 15.
25 *Id.* at 32-33.

Insider Trading & Disclosure Update is a publication of

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