Big Stakes In High Court's Securities Fraud Omissions Case

By **Stephen Cohen and Daniel McLaughlin, Sidley Austin LLP** April 19, 2017, 12:38 PM EDT

In its October 2017 term, the U.S. Supreme Court will hear a case, Leidos Inc. v. Indiana Public Retirement System, raising fundamental questions about the nature and sources of liability for nondisclosures under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.[1] For public companies, the practical impact of Leidos is that the court will decide if violations of U.S. Securities and Exchange Commission disclosure rules in a Form 10-K can trigger a securities class action even if nothing said in the Form 10-K is false or misleading. This could have broader implications for numerous other disclosure obligations, such as those arising under Regulation M-A.

False statements and omissions are the two main sources of civil and criminal liability under Section 10(b). Claims based on omissions, however, may really be about statements, if the omitted fact made a statement misleading. But if there's no false or misleading statement at all, nondisclosure claims have long required a "duty to disclose." Leidos asks whether a private Section 10(b) claim can rest entirely on the omission of information where the duty to disclose arises from an SEC regulation, specifically Item 303 of Regulation S-K.[2] To answer that question, the court may have to decide what source of law creates duties to disclose for purposes of a fraud claim under Section 10(b): federal or state, regulations or common law. The outcome likely will affect SEC enforcement actions as well as private securities litigation.

Statutory Background

Section 10(b) makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security ... *any manipulative or deceptive device or contrivance* in contravention of *such rules and regulations* as the [SEC] *may prescribe* ...."[3] The statute never mentions misrepresentations or omissions or defines "deceptive device or contrivance." Rule 10b-5(b) 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*, in the light of the circumstances under which they were made, *not misleading*."[4] It does not address omissions when no statement is made; neither do Rules 10b-5(a) or (c), which make it unlawful, respectively, to "employ any device, scheme, or artifice to defraud" and to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," in connection with securities transactions.

The Supreme Court has repeatedly held that liability requires a violation of both the statute and the rule. In 1976, the court noted that the language of Rules 10b-5(b) and (c) did not require proof of intent, but the statute controlled: "[t]he rulemaking power granted to an administrative agency ... is not the power to make law ... despite the broad view of the Rule advanced by the [SEC] in this case, *its scope can not exceed the power granted the [SEC] by Congress under §*

10(b)."[5] In rejecting private aiding and abetting liability, the court held: "[w]e cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute."[6] When the court found that a party did not "make" a statement within the terms of Rule 10b-5(b), it looked no further.[7]

The court often considers other provisions of the 1933 and 1934 Acts in construing Section 10(b).[8] In Section 11 of the Securities Act of 1933, Congress allowed civil lawsuits when a registration statement "contained an untrue statement of a material fact or omitted to state a material fact *required to be stated therein* or necessary to make the statements therein not misleading".[9] This "required to be stated therein" language also appears in Section 10(b) of the 1933 Act (SEC authority to suspend a prospectus) and Section 15(b)(4)(a) of the 1934 Act (SEC authority to sanction broker-dealers).[10] But it is conspicuously absent from other provisions addressing false or misleading statements. In the 1933 Act, there is no reference to required disclosures in Sections 12(a)(2) (private suits over prospectus statements) or 17(a)(2) (the anti-fraud rule on which Rule 10b-5(b) is modeled).[11] The 1934 Act refers repeatedly to false or misleading statements without mentioning required disclosures, including in the two express private rights of action, Sections 9(a)(4) (market manipulation) and 18(a) (statements in periodic reports such as Forms 10-K), as well as Sections 14(e) (proxy statements), 32(a) (criminalizing willfully making any "statement [that] was false or misleading as to any material fact" in a required filing), and three sections of the Private Securities Litigation Reform Act of 1995: Sections 21D(b)(1)(b) (pleading requirements), 21D(f)(10)(i) (contribution), and 21E(c)(1) (safe harbor for forward-looking statements).[12]

Thus, while Congress chose to create omissions liability for required disclosures in a few specific contexts, it is not the norm in the securities laws, and neither Section 10(b) nor Rule 10b-5(b) includes such language. Omissions of required disclosures cannot be assumed, therefore, to be automatically covered. At a minimum, some theory is required for why an omission is deceptive and fraudulent.

Duty to Disclose What to Whom?

Despite their absence from the text, duties to disclose have long been an important dividing line for the court: "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5."[13] Disclosure duties — often framed in terms of fiduciary or similar duties of trust and confidence — loom large in the court's insider trading and civil and criminal enforcement cases: "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak ... premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction."[14] Breaches of insider duties not to personally profit from corporate information supply the "deceptive device" to make insider trading a Section 10(b) violation.[15] Unauthorized trading by a broker with discretionary authority violates Section 10(b) because "any distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients."[16]

The court first imposed private damages liability for silence in Affiliated Ute Citizens v. United States, which held that market makers "possessed the affirmative duty under [Rule 10b-5] to disclose" certain facts to unsophisticated sellers of securities in face-to face transactions.[17] The "obligation to disclose" arising from this relationship led the court to presume that the investors relied on the nondisclosure.[18] Later decisions emphasized that the duty to disclose is central to the causal connection between an omission and an investor's presumed reliance on someone who owed them duties.[19] The court took a similar view of representations implied from conduct in face-to-face transactions.[20]

While the court has always spoken of duties to disclose in terms of a relationship of trust and confidence between the parties, it has never resolved precisely what source of law gives rise to such duties: must pre-existing state law impose a duty, or does federal securities law supply its own duties? If so, may they be created by the courts through common-law decisions, or by the SEC through administrative rule-making?

Item 303 is not just any SEC disclosure rule. Titled "management's discussion and analysis of financial condition and results of operations," it requires public companies in annual reports on Form 10-K to discuss and analyze several categories of "known trends or uncertainties" that may affect their capital, sales, revenues and liquidity.[21] This is inherently a forward-looking inquiry, and by definition, it addresses uncertainties.

The SEC adopted Item 303 under its general authority over periodic disclosures to the market as a whole, unconstrained by any fiduciary or similar relationship; it is one of many such SEC disclosure rules. But other SEC rules derive explicitly from its power to proscribe fraud. Some require specific disclosures (Rule 10b-17), while others refer only to affirmative statements (Rules 10b-9, and 14a-9), or relationships of trust and confidence (Rule 10b5-2); still others speak generally of deception (Rule 10b-18).[22] Other SEC rules are prophylactic disclosures not easily characterized solely as bans on fraudulent activity (e.g., Rules 9b-1, 10b-10, 10b-16, and 14a-3).[23] Will the court in Leidos treat all rule-based disclosure duties the same?

Circuit Split

The Second Circuit held in 2015 that failure to discuss a trend or uncertainty covered by Item 303 violates Section 10(b) if the undisclosed fact was material:

[W]e have consistently held that an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts. ... Such a duty may arise when there is corporate insider trading on confidential information, *a statute or regulation requiring disclosure*, or a corporate statement that would otherwise be inaccurate, incomplete, or misleading.[24]

This opened a split with the Ninth Circuit and, arguably, the Third Circuit.[25] But that decision, involving a financial institution's exposure to the mortgage market, dismissed the complaint for failure to plead that the nondisclosure was reckless.[26] The circuit split awaited a live case, which arrived in 2016 when the Second Circuit sustained an Item 303-based complaint involving a kickback investigation that led to the loss of a government contract.[27] The Second Circuit cautioned that the language of "Item 303 requires the registrant to disclose only those trends, events, or uncertainties that it *actually knows of when it files the relevant report* with the SEC. It is *not enough that it should have known* of the existing trend, event, or uncertainty."[28] The petition in Leidos followed.

Practical Impact

Leidos presents potentially far-reaching questions, ranging from the SEC's role in interpreting Section 10(b) to courts' role in creating a federal common law of disclosure duties. Omissions liability for required disclosures is a frequent tool in the arsenal of the SEC and prosecutors, in light of the profusion of SEC rules and the ability to target nonspeaking parties. It is also a powerful weapon in civil class actions, given that an omission case allows class plaintiffs to bypass the need to show individual reliance. Applied to forward-looking projections like those required by Item 303, it can open public companies to significant second-guessing class actions when the company faces a downturn or crisis after misjudging uncertainties that seem obvious only in hindsight.

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[1] No. 16-581.

[2] 17 C.F.R. § 229.303.

[3] 15 U.S.C. § 78j(b) (emphasis added herein except where otherwise indicated).

[4] 17 C.F.R. § 240.10b-5(b).

[5] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213-14 (1976).

[6] Central Bank of Denver NA v. First Interstate Bank of Denver NA, 511 U.S. 164, 175 (1994).

[7] Janus Capital Group Inc. et al. v. First Derivative Traders, 564 U.S. 135, 142 (2011).

[8] See, e.g., Musick Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 294-97 (1993).

[9] 15 U.S.C. § 77k.

[10] 15 U.S.C. §§77j(a) & 78o(b)(4)(a).

[11] 15 U.S.C. §§ 77l & 77q(a)(2).

[12] 15 U.S.C. §§ 78i(a)(4), r(a), n(e), ff(a), u-4(b)(1)(b) & (f)(10)(i) & u-5(c)(1).

[13] Basic Inc. v. Levinson, 485 U.S. 224, 239 n. 17 (1988).

[14] Chiarella v. United States, 445 U.S. 222, 230, 235 (1980).

[15] See, e.g., Salman v. United States, 137 S. Ct. 420, 421 (2016) ("persons bound by a duty of trust and confidence"); United States v. O'Hagan, 521 U.S. 642, 655 (1997) ("feigning fidelity to the source of information" by a "fiduciary-turned-trader").

[16] SEC v. Zandford, 535 U.S. 813, 822-23 (2002).

[17] Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972) (emphasis added).

[18] Id. at 153-54.

[19] See Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc., 552 U. S. 148, 159 (2008); Basic, 485 U.S. at 243.

[20] See The Wharf (Holdings) Ltd. v. United Int'l Holdings Inc., 532 U.S. 588, 596 (2001).

[21] 17 C.F.R. § 229.303.

[22] See 17 C.F.R. §§ 240.10b5-2, 240.10b-9, 240.10b-17, 240.10b-18, & 240.14a-9.

[23] See 17 C.F.R. §§ 240.9a-1, 240.10b5-10, 240.10b-16, & 240.14a-3.

[24] Stratte–McClure v. Morgan Stanley, 776 F.3d 94, 100-01 (2d Cir. 2015) (emphasis added; quotations omitted).

[25] See In re NVIDIA Corp. Securities Litigation, 768 F.3d 1046 (9th Cir.2014); Oran v. Stafford, 226 F.3d 275, 288 (3d Cir.2000) (Alito, J.).

[26] See Stratte-McClure, 776 F.3d at 106-07.

[27] Indiana Public Retirement System v. SAIC Inc., 818 F.3d 85, 89-90, 95 (2d Cir. 2016).

[28] Id. at 95 & n. 8 (emphasis added).