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# Much Ado About Nothing: The Limits of Liability for Item 303 Omissions and the Circuit Split That Never Was

Brian Currie

# MUCH ADO ABOUT NOTHING: THE LIMITS OF LIABILITY FOR ITEM 303 OMISSIONS AND THE CIRCUIT SPLIT THAT NEVER WAS

BRIAN CURRIE*

ABSTRACT

*The implied private action for violations of SEC Rule 10b-5 has a contentious history. When plaintiffs base such actions on representations of forward-looking information, however, the stakes are even higher. Recently, the federal circuit courts revisited this divisive issue while deciding whether an omission from required disclosure of Management's Discussion and Analysis (MD&A) of financial conditions and results of operations. The apparent disparity between the federal circuit courts has caused great consternation and uncertainty in the corporate legal sphere.*

*This Note will examine the origins and controversial history of Rule 10b-5 private actions, discuss the treatment of MD&A omissions throughout the various federal circuits, offer a harmonized reading that resolves the perceived difference between the circuits, and explain how this reading satiates the concerns of both proponents and opponents of increased securities disclosure.*

> *When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.*[1]
>
> —*Justice William Rehnquist*

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*J.D. Candidate, 2017, William & Mary Law School; B.A., 2006, Purdue University. Many thanks to my wife, Becky, and daughters, Felicity and Anastasia, for their unwavering support over the past three years. I am also indebted to the staff and editorial board of the *William & Mary Business Law Review* for their invaluable assistance in refining this Note for publication.

[1] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975). Justice Rehnquist penned this oft-quoted phrase when a case confronted the Court with the prospect of extending Rule 10b-5 liability. *Id.*

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## INTRODUCTION

Recently, a great commotion has erupted around the "judicial oak" of Rule 10b-5 private actions. At its center is the debate over whether to include omissions from Item 303 of Regulation S-K as a basis for satisfying the materiality prong of Rule 10b-5 liability.[2] Within the last year, the Second and Ninth Circuit Courts of Appeals both ruled on whether an omission on Item 303[3] of Regulation S-K[4] could satisfy the materiality standard for Rule 10b-5[5] civil actions.[6] To the concern of many,[7] the Second Circuit's opinion announced that its decision was a clear split with the Ninth Circuit.[8]

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[2] *See generally* Douglas Flaum, Kevin Broughel & Inna Coleman, *Second Circuit Finds That Failure to Make Required Item 303 Disclosure Can Provide Basis for Securities Fraud Claim*, PAUL HASTINGS: STAY CURRENT (Jan. 29, 2015), http://www.paulhastings.com/publications-items/details/?id=908de369-2334-6428-811c-ff00004cbded [https://perma.cc/XDJ3-WU5S] (anticipating a Supreme Court decision to settle the discrepancy); John Stigi & Madalyn Macarr, *Second Circuit Notes Split with Ninth Circuit Over Whether Failure to Make Adequate Disclosures Under Item 303 of Regulation S-K May Serve as Basis for a Section 10(b) Claim*, SHEPPARDMULLIN: CORP. & SEC. L. BLOG (Jan. 26, 2015), http://www.corporatesecuritieslawblog.com/2015/01/second-circuit-notes-split-with-ninth-circuit-over-whether-failure-to-make-adequate-disclosures-under-item-303-of-regulation-s-k-may-serve-as-basis-for-a-section-10b-claim [https://perma.cc/U5GN-2JVM] (noting a "clear" circuit court split that requires Supreme Court intervention to resolve); Jonathan C. Dickey & Noah F. Stern, *Creating a Clear Circuit Court Split, the Second Circuit Holds that Failure to Disclose Known Trends Or Uncertainties Under Item 303 of Regulation S-K Creates Liability Under Section 10(b)*, GIBSON DUNN (Jan. 22, 2015), http://www.gibsondunn.com/publications/Documents/Second-Circuit--Failure-to-Disclose-Known-Trends-or-Uncertainties-Under-Item-303--Regulation%20S-K-Creates-Liability.pdf [https://perma.cc/LQ2X-HD2S] (cautioning clients to carefully review their Item 303 disclosures to prevent action from plaintiff's attorneys); Michael Eisenkraft, *Can Silence Keep You Safe? New Debate On 10b-5 Liability*, LAW360 (Jan. 20, 2015), http://www.law360.com/articles/612920/can-silence-keep-you-safe-new-debate-on-10b-5-liability [https://perma.cc/8S9D-CAEK] (predicting Supreme Court intervention to resolve the circuit court split).

[3] 17 C.F.R. § 229.303 (2016).

[4] *Id.* § 229.

[5] *Id.* § 240.10b-5.

[6] *See* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 103 (2d Cir. 2015); *see also* Cohen v. NVIDIA Corp., 768 F.3d 1046, 1054 (9th Cir. 2014).

[7] *See, e.g.*, Dickey & Stern, *supra* note 2, at 1.

[8] *Stratte-McClure*, 776 F.3d at 103–04.

Because over half of all securities litigation in the United States is adjudicated in these two jurisdictions,[9] the immediate reaction from the legal sphere was—understandably—to alert corporate clients to the potentially disastrous consequences of failing to carefully analyze their Item 303 disclosures in light of the circuit split.[10] Adding gravity to the debate, the Fifth Circuit District Court for the District of Minnesota, in a subsequent decision, chose to follow the Second Circuit's holding that Item 303 omissions can form the basis of a Rule 10b-5 action.[11] Despite all of the commotion, the Supreme Court chose not to address the issue when given the opportunity.[12]

This Note explores the background and origins of the Ninth and Second Circuit Courts of Appeals' opinions, identifies a way of reading the two opinions to resolve the superficial differences between them, and argues that such a harmonized reading of those decisions satisfies the major concerns of both proponents and opponents of private securities litigation. Part I gives context to the current debate over Item 303 by explaining the history and requirements of Item 303 and its role in the broader scheme of Regulation S-K and Rule 10b-5—the plaintiffs' basis for relief in both *Cohen* and *Stratte-McClure*. Part II explores the specific factual and legal reasoning behind *Oran*[13]—the case upon which the split circuits both claim to base their reasoning—as well as how treatment of that case differed between *Cohen*, *Stratte-McClure*, and *Beaver County*. Finally, Part III discusses how the inclusion of Item 303 as a possible basis for Rule 10b-5 violations will satisfy the concerns of both opponents and supporters of private Rule 10b-5 litigation.

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[9] *See* FAIZAL KARIM & ANTHONY GALLO, COMING INTO FOCUS: 2014 SECURITIES LITIGATION STUDY 21 (Neil Keenan & Patricia Etzold eds., 2015), https://www.pwc.com/us/en/forensic-services/publications/assets/2014-securities-litigation-study.pdf [https://perma.cc/3FTD-QZMS].

[10] *See generally* Flaum et al., *supra* note 2; Dickey & Stern, *supra* note 2.

[11] Beaver Cty. Emps.' Ret. Fund v. Tile Shop Holdings, Inc., 94 F. Supp. 3d 1035, 1047 (D. Minn. 2015).

[12] Cohen v. NVIDIA Corp., 768 F.3d 1046 (9th Cir. 2014), *cert. denied*, 135 S. Ct. 2349 (2015).

[13] Oran v. Stafford, 226 F.3d 275 (3d Cir. 2000).

## I. LEGISLATIVE AND ADMINISTRATIVE STANDARDS FOR DISCLOSURE OF FORWARD-LOOKING "SOFT INFORMATION"

### *A. The History of Forward-Looking Disclosures*

Because forward-looking projections are little more than educated estimates, securities specialists refer to it as "soft information."[14] Prior to 1972, the Securities Act of 1933[15] and the Securities Exchange Act of 1934[16] generally prohibited projection—that is, "forward-looking" filings.[17] Although a full history of such disclosures is beyond the scope of this Note, a fundamental understanding of the reasoning behind such omissions is necessary.

Generally, supporters of such an approach gave three rationales for the exclusion of these forward-looking projections.[18] First, supporters believed that the government's duty was to protect unsophisticated investors from "their own ignorance" regarding whether soft information was reliable or not.[19] Second, proponents believed (paradoxically, in light of the first rationale) that investors were capable of making their own predictions regarding a corporation's future performance.[20] The third and final justification was that forward-looking projections were not "facts" per se.[21]

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[14] Using the term "soft information" to refer to a corporation's future condition or performance contrasts with the idea of "hard" information, which is known, unchangeable, historical data about a corporation's past performance. SHARON L. FULLEN, HOW TO GET FINANCING FOR YOUR NEW SMALL BUSINESS: INNOVATIVE SOLUTIONS FROM THE EXPERTS WHO DO IT EVERY DAY 213 (2006) (defining "soft" information as opinions, guesses, and prediction in the context of securities law); Joel Seligman, *Colloquium: The SEC's Unfinished Soft Information Revolution*, 63 FORDHAM L. REV. 1953, 1953 (1995) (contrasting the nature of "soft information" and "hard information").

[15] 15 U.S.C. § 77a (2012).

[16] *Id.* § 78a.

[17] LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 230 (6th ed. 2011).

[18] *Id.*

[19] *Id.* (quoting Report of the Advisory Comm. on Corp. Disclosure to the SEC, H.R. Comm. on Interstate & Foreign Commerce, 95th Cong., 1st Sess. 348 (Comm. Print 1977)).

[20] LOSS ET AL., *supra* note 17, at 230.

[21] *Id.*

By the 1970s, however, the Securities and Exchange Commission's (SEC) policy against allowing forward-looking disclosures faced serious criticism.[22] In the face of such criticism, the SEC ultimately capitulated and gave forward-looking statements a permanent home in SEC filings under Regulation S-K.[23] The subsequent two decades saw an increasingly litigious atmosphere and greater prominence of forward-looking statements.[24] Concurrently, the SEC slowly moved from "an emphasis on hard facts to ... [an] emphasis on ... predictive information."[25]

In 1989, the SEC adopted Item 303, the centerpiece of the current firestorm.[26] Commentators have referred to Item 303 as "the most important textual disclosure item in Regulation S-K."[27] Textually, Item 303 requires managers to disclose the corporation's financial status, any changes in such financial condition, and anticipated results of operations.[28] While Item 303 lists several subcategories,[29] perhaps the most onerous for management is the requirement of subsection (a)(3)(ii).[30] Subsection (a)(3)(ii)—regarding the "results of operations"—requires managers to perform the following:

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[22] *See* JEREMY L. WIESEN, REGULATING TRANSACTIONS IN SECURITIES 311–19 (1975) (offering a critique of the SEC's disclosure requirements and their shortfalls, including references to ongoing efforts to include forward-looking statements in disclosures); *see also* Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1197–98 (1970) (offering another scathing critique of many SEC policies and asserting that investors are most interested, *inter alia*, in earnings projections).

[23] *See* LOSS ET AL., *supra* note 17, at 231–35.

[24] *Id.* at 236. For a complete account of this remarkable turnaround in SEC disclosure policy, see generally Joel Seligman, *Colloquium: The SEC's Unfinished Soft Information Revolution*, 63 FORDHAM L. REV. 1953 (1995).

[25] LOSS ET AL., *supra* note 17, at 265.

[26] MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 166 (6th ed. 2014); *see also* 43 SEC Docket 1330 (1989).

[27] LOSS ET AL., *supra* note 17, at 264. Item 303 has given rise to a fair amount of private litigation, and the liability for Item 303 omissions under the Securities Act of 1933 is well established. *See generally* Silverstrand Invs. v. AMAG Pharm., Inc., 707 F.3d 95 (1st Cir. 2013) (discussing liability under § 11 of the Securities Act of 1933 for Item 303 omissions); J&R Mktg., SEP v. GMC, 549 F.3d 384 (6th Cir. 2008) (discussing liability under § 12 of the Securities Act of 1933 for Item 303 omissions).

[28] 17 C.F.R. § 229.303(a) (2011).

[29] *Id.* § (a)(1)–(5).

[30] *Id.* § (a)(3)(ii).

> [D]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations. If the registrant knows of events that will cause a material change in the relationship between costs and revenues ... the change in the relationship shall be disclosed.[31]

Management must file Item 303 disclosures on an annual basis.[32] Furthermore, any "material" changes in operations or financial condition must be updated as required in the interim period.[33]

The SEC provides instructions about weighing the materiality—the threshold standard for disclosure requirements—of forward-looking information in Item 303.[34] The agency requires that management make two assessments in determining materiality for the purposes of Item 303 disclosure.[35] First, management must reasonably assess the likelihood of a known trend or uncertainty coming to fruition.[36] If the answer to this inquiry is "low," then no disclosure is required.[37] On the other hand, if no determination can be reasonably made, management must objectively assess the consequences if this trend or uncertainty occurs.[38] Management must disclose this information unless it determines that the known trend or uncertainty is not reasonably likely to have a material effect on the corporation's financial condition or results of operations.[39]

From their humble beginnings, forward-looking statements have seen a remarkable rise to becoming the centerpiece of securities litigation.[40] Equally remarkable is that the failure to submit

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[31] *Id.*

[32] *Id.* § (a).

[33] *Id.* § (b).

[34] 54 Fed. Reg. 22,427, 22,429–30 (May 24, 1989).

[35] *Id.* at 22,430.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] *See* Allan Horwich, *Cleaning the Murky Safe Harbor for Forward-Looking Statements: An Inquiry into Whether Actual Knowledge of Falsity Precludes the Meaningful Cautionary Statement Defense*, 35 J. CORP. L. 519, 520–21 (2010) (commenting on the growth of forward-looking statements from prohibited disclosure to "the most common basis for a private damage claim under the federal securities laws").

forward-looking disclosures, a once prohibited practice, now triggers a whole host of serious SEC enforcement actions.[41] Forward-looking statements have become an increasingly dangerous source of liability and consternation for corporate firms and their legal counsel.[42] In their current context, the importance of forward-looking disclosures has combined with Item 303's detailed standard for materiality to create the current discrepancy among the circuit courts of appeals.[43]

### *B. Standard for Actionable Omissions Under Rule 10b-5*

In order to understand how the requirements of Item 303 contrast and overlap with the materiality of Rule 10b-5 (and, thus, lay the foundation for understanding the current circuit court split), a basic understanding of Rule 10b-5's history and judicial standards merit discussion. Rule 10b-5 was first promulgated in 1942 pursuant to authority granted under § 10(b) of the Securities Exchange Act of 1934.[44] While originally designed

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[41] Under the 1933 Act, misstatements or omissions on required forward-looking disclosures can lead to criminal or civil sanctions under sections 11, 12(a)(1), 12(a)(2), or 17(a). *See* 15 U.S.C. §§ 77k, 77l(a)(1), 77l(a)(2), 77(q) (2012).

[42] *See generally* Robert J. Mallonek & Paul A. Serritella, *'Panther Partners' and Disclosure of Trends Under Item 303*, N.Y. L.J. (Sept. 11, 2012), LEXIS (discussing the broadening liability for Item 303 omissions and noting that interest in liability for forward-looking statements is growing); Matthew L. Mustokoff, *Is Item 303 Liability under the Securities Act Becoming a "Trend"?*, http://apps.americanbar.org/litigation/committees/securities/email/summer2012/summer2012-0912-is-item-303-liability-under-securities-act-becoming-trend.html [https://perma.cc/S5D4-J7KN] (discussing the increasing liability for Item 303 omissions under various provisions of the Securities Act of 1933).

[43] One line from the Federal Register—relied upon by the circuit courts in their decisions—nicely illustrates the underlying legal headache regarding the materiality of Item 303 omissions: "the ... test for materiality approved by the Supreme Court [for Rule 10b-5] ... is inapposite to Item 303 disclosure." 54 Fed. Reg. 22,427, 22,430 n.27 (May 24, 1989).

[44] Justin Marocco, *When Will It Finally End: The Effectiveness of the Rule 10b-5 Private Action as a Fraud-Deterrence Mechanism Post-*Janus, 73 LA. L. REV. 633, 633 (2013); *see also* Securities Exchange Act of 1934, Pub. L. 73-291, § 10b, 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2012)) (prohibiting the use of "manipulative or deceptive device[s]" in connection with the purchase or sale of a security, and impliedly granting the SEC enforcement power via "necessary or appropriate" rules and regulations); 17 C.F.R. § 240.10b-5 (2015).

as a gap-filling measure,[45] it took less than four years for this agency-empowering rule to spawn an implied private right of action.[46] Eventually the Supreme Court "established that a private right of action is implied under [Rule 10b-5]."[47]

The elements of the implied private action under Rule 10b-5 claims are (1) a material misrepresentation or omission; (2) scienter; (3) a connection between the misrepresentation and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.[48] As mentioned above, the current circuit court split revolves around the materiality requirement—specifically the idea of a "material omission."

In its seminal decision, the Supreme Court held in *Basic v. Levinson* that an actionable statement (or omission) must be misleading, but that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5."[49] Regarding required forward-looking disclosures, the Court formulated a specific test for the materiality of such statements: courts must "balanc[e] ... 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."[50]

### *C. Special Considerations for Private Securities Litigation Under the Private Securities Litigation Reform Act*

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA)[51] to protect defendants from frivolous class action suits under the Securities Exchange Act of 1934.[52] The

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[45] HAROLD S. BLOOMENTHAL & SAMUEL WOLF, SECURITIES LAW HANDBOOK § 27:2 (2015 ed.). Considering the prominence of Rule 10b-5 in modern securities jurisprudence, it is interesting to note that an ad-hoc committee very hastily drafted the rule in less than a day. *See* Milton V. Freeman, *Colloquium Foreword*, 61 FORDHAM L. REV. S1, S1–S2 (1993).

[46] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

[47] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[48] Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1317 (2011).

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

[50] *Id.* at 238 (quoting SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

[51] Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. § 78j (2011)); *see also* BLOOMENTHAL & WOLF, *supra* note 45, § 1:15.

[52] BLOOMENTHAL & WOLF, *supra* note 45, § 1:15.

most obvious protection of the PSLRA, the "safe harbor" provisions, would apply to the inclusion of Item 303 omissions.[53] The "safe harbor" provisions of the PSLRA offer blanket protection for forward-looking "soft information" in three circumstances:

> (1) the *statement* is identified as forward-looking and is accompanied by sufficient cautionary statements;
> (2) the *statement* is immaterial; or
> (3) if the plaintiff is unable—with regards to a natural person defendant—to adequately show scienter or—with regards to a corporate defendant—to prove that the *statement* was made by (or with approval of) an executive officer.[54]

While the impossibility of qualifying an omission as "forward-looking" excludes the first possible "safe harbor," the second and third provisions above apply directly to provision Item 303 omissions.[55] Notably, these "safe harbors" played a significant role in the litigation in both *Cohen* and *Stratte-McClure*.[56]

## II. Treatment of Item 303 Omissions in Rule 10b-5 Actions Among the Circuit Courts

### *A. The Third Circuit Court of Appeals*—Oran v. Stafford

In coming to their respective holdings regarding actionability of Item 303 omissions, the Ninth and Second Circuit Courts of Appeals (as well as the district court for the District of Minnesota) relied heavily on a Third Circuit Court of Appeals opinion authored by then-Judge Alito that pre-dated his Supreme Court tenure.[57]

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[53] *Id.* § 28:6.

[54] *Id.* (emphasis added).

[55] *See* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 103–04 (2d Cir. 2015) (noting that an omission that satisfies the Item 303 materiality test would also need to pass a heightened standard of materiality); Cohen v. NVIDIA Corp., 768 F.3d 1046, 1056 (9th Cir. 2014) (holding that the Item 303 disclosures on which plaintiffs based their claim failed to satisfy the "materiality" requirement).

[56] *Stratte-McClure*, 776 F.3d at 103–04; *Cohen*, 768 F.3d at 1056.

[57] *See Stratte-McClure*, 776 F.3d at 103; *Cohen*, 768 F.3d at 1055–56; Beaver Cty. Emps.' Ret. Fund v. Tile Shop Holdings, Inc., 94 F. Supp. 3d 1035, 1047–48 (D. Minn. 2015).

### 1. *The Background to* Oran v. Stafford

*Oran* was an appeal of summary judgment against the plaintiff-purchasers in favor of the defendant-corporation.[58] The district court found that plaintiffs failed to plead any material misstatement or omission as required by Rule 10b-5.[59] The plaintiffs contended that the defendants (American Home Products Corporation and certain officers and directors) had violated Rule 10b-5 by failing to disclose information regarding the potential negative side effects of the corporation's pharmaceutical products.[60] The district court[61] dismissed the plaintiffs' complaints for failing to state a material omission.[62] On appeal, the plaintiffs contended that the district court erred in holding that a violation of Item 303 cannot satisfy the materiality prong of a Rule 10b-5 private securities claim.[63]

### 2. *The Holding in* Oran

In addressing the plaintiffs' claims regarding Item 303, the Third Circuit first resolved the question of whether Item 303 creates an independent private right of action.[64] Although a previous appellate decision had left this question open,[65] the Third Circuit spared little time rejecting this proposition—disposing of the idea in two sentences.[66]

Plaintiffs further contended, in the alternative, that Item 303 "imposes an affirmative duty of disclosure ... that, if violated, would constitute a *material omission* under Rule 10b-5."[67] In coming to its decision, the Third Circuit considered the disparity regarding the definition of "materiality" for the purpose of Item 303 as

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[58] Oran v. Stafford, 226 F.3d 275, 281 (3d Cir. 2000).
[59] *Id.* at 288.
[60] *See id.* at 275–80.
[61] Oran v. Stafford, 34 F. Supp. 2d 906 (D.N.J. 1999).
[62] *See supra* notes 47–50 and accompanying text (thoroughly discussing 10b-5's materiality requirement regarding omissions).
[63] *Oran*, 226 F.3d at 281.
[64] *Id.* at 287.
[65] *Id.* (quoting *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1418 n.7 (3d Cir. 1997)).
[66] *Id.*
[67] *Id.* (emphasis added).

compared with that for the purpose of establishing Rule 10b-5 liability.[68] The court noted "[the Item 303 disclosure] test varies considerably from the general test for securities fraud materiality set out by the Supreme Court in *Basic, Inc. v. Levinson*."[69] Most damning, however, was the SEC's own assessment of the different standards—stating that the Rule 10b-5 standard from *Basic* is "inapposite to Item 303 disclosure."[70]

In its ultimate conclusion on the matter, the Third Circuit held that, because Item 303's materiality standards required more than Rule 10b-5, "a violation of [Item 303's] reporting requirements does not *automatically* give rise to a material omission under Rule 10b-5."[71] The court, however, also penned language requiring that plaintiffs "*must ... separately show*" a Rule 10b-5 duty to disclose and that perhaps an Item 303 disclosure *could* support a Rule 10b-5 claim.[72]

The *Oran* opinion suggests that the plaintiffs' mistake was not in using an Item 303 omission as the basis for a Rule 10b-5 action, but rather an insufficient pleading.[73] The opinion notes that materiality under Item 303's disclosure requirements does not *inevitably* lead to the conclusion that such disclosure is also material as required under Rule 10b-5.[74] As noted above, the Third Circuit fell far short of claiming that an Item 303 omission can *never* form the basis of a Rule 10b-5 action.[75] Rather, the appellate decision only suggests that an Item 303 omission must be properly pled as satisfying the heightened standard for Rule 10b-5 omissions.[76] This ruling, while apparently clear on its face, laid the foundation for the current controversy between the Second and Ninth Circuits' readings of *Oran*.

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[68] *Id.* at 287–88.

[69] *Id.* at 288.

[70] *Id.* (quoting 54 Fed. Reg. 22,430 n.27 (May 24, 1989)).

[71] *Id.* (emphasis added). This emphasized language will become important in reconciling the Second and Ninth Circuit opinions below.

[72] *Id.* (emphasis added).

[73] *Id.*

[74] *Id.*

[75] *See supra* notes 70–71, and accompanying text.

[76] *Oran*, 226 F.3d at 288.

### *B. The Ninth Circuit Court of Appeals*—Cohen v. NVIDIA Corp.

#### *1. The Background to* Cohen

*Cohen*, similar to *Oran*, involved a class action securities litigation against a corporate defendant.[77] Plaintiffs claimed that NVIDIA Corp. (NVIDIA), a manufacturer of computer chips and semiconductors, had failed to disclose material information regarding potential problems with the solder used on its microchips.[78] When the problems with the solder became widely known, NVIDIA's share price dropped by 31 percent.[79] Consequently, plaintiff-investors filed suit under, inter alia, the theory that NVIDIA and its directors had violated Rule 10b-5 by omitting the known solder issues from its Item 303 disclosures.[80]

#### *2. The* Cohen *Court's Reading of* Oran *and Ultimate Holding*

*Cohen*, like *Oran*, was an appeal of summary judgment against the plaintiff-purchasers in favor of the defendant-corporation for failure to state a claim upon which relief could be granted.[81] Specifically, the district court took issue with the plaintiffs' inadequate pleading of both scienter and materiality in relation to their Rule 10b-5 claim.[82] The plaintiffs contended that NVIDIA violated Rule 10b-5 by failing to disclose reports of serious defects in its computer chips.[83] On appeal, the plaintiffs contended that the district court erred in holding that violation of Item 303 could not satisfy the materiality prong of a Rule 10b-5 claim.[84] Subsequently, the court—relying in part on its reading of *Oran*—held that Item 303 does not create a duty to disclose for purposes of Rule 10b-5.[85]

In reaching this conclusion, the Ninth Circuit began echoing the analysis laid out in *Oran* by comparing the materiality

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77 Cohen v. NVIDIA Corp., 768 F.3d 1046, 1048–51 (9th Cir. 2014).

78 *Id.*

79 *Id.* at 1050–51.

80 *Id.* at 1051.

81 *Id.* at 1048; *Oran*, 226 F.3d at 281.

82 *Cohen*, 768 F.3d at 1048; *see also* Securities Exchange Act of 1934, Pub. L. 73-291, § 10b, 48 Stat. 881, 891 (1934) (codified as amended at 15 U.S.C. § 77j(b) (2012)); 17 C.F.R. § 240.10b-5 (2015).

83 *See Cohen*, 768 F.3d at 1048–51.

84 *Id.* at 1048.

85 *Id.* at 1056.

requirements of Item 303 and Rule 10b-5.[86] The *Cohen* court went further than *Oran's* analysis: it added that "[m]anagement's duty to disclose under Item 303 is much broader than what is required under the standard [for Rule 10b-5]."[87] Also similar to *Oran*, the Ninth Circuit noted that even the strongest cases supporting the plaintiffs' position were unavailing.[88]

The language of the Ninth Circuit's ultimate holding in *Cohen* closely mirrors that of *Oran*.[89] The court held that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5.[90] Such a duty to disclose *must be separately shown* according to the principles set forth by the Supreme Court in *Basic* and *Matrixx Initiatives*."[91] This language seems to implicate that the plaintiffs' Item 303 claim did not run afoul of some newly created blanket immunity from Rule 10b-5 liability for Item 303 omissions, but that the language failed to adequately plead such an omission satisfied the Rule 10b-5 standard (the "something more").[92]

### *C. The Second Circuit Court of Appeals*—Stratte-McClure v. Morgan Stanley

#### *1. The Background of* Stratte-McClure

*Stratte-McClure v. Morgan Stanley* also involved a class action lawsuit by plaintiff-investors against a corporate defendant.[93] Here,

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[86] *Id.* at 1055; *accord. Oran*, 226 F.3d at 288.

[87] *Cohen*, 768 F.3d at 1055.

[88] Plaintiffs relied upon a District of Rhode Island case from 1996, in which the court stated that Item 303 imposed an "affirmative duty to disclose." Simon v. Am. Power Conversion Corp., 945 F. Supp. 416, 431 (D.R.I. 1996). However, that point was clarified in a later opinion by the same District Judge, noting that "plaintiffs may not rely solely upon Item 303 to prove materiality in violation of Rule 10b-5." Kafenbaum v. GTECH Holdings Corp., 217 F. Supp. 2d 238, 250 (D.R.I. 2002).

[89] *Compare Cohen*, 768 F.3d at 1056 ("[A] duty to disclose [on Item 303 for the purposes of establishing Rule 10b-5 liability] must be separately shown according to the principles set forth by the Supreme Court in *Basic* and *Matrixx Initiatives*."), *with Oran*, 226 F.3d at 288 ("A violation of [Item] 303's reporting requirements does not automatically give rise to a material omission under Rule 10b-5. Because plaintiffs have failed to plead any actionable misrepresentation or omission under [Rule 10b-5], [Item] 303 cannot provide a basis for liability.").

[90] *Cohen*, 768 F.3d at 1056.

[91] *Id.* (emphasis added).

[92] *Id.* at 1054–56.

[93] Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 96 (2d Cir. 2015).

the corporate defendant was investment firm Morgan Stanley.[94] Plaintiffs contended that Morgan Stanley failed to disclose its losses in the subprime mortgage market.[95] Morgan Stanley's extensive exposure in this area would eventually cost the firm billions of dollars as the subprime market began to collapse.[96] As the market reacted to this news, the firm's stock price fell by 29 percent.[97] Consequently, plaintiffs filed suit alleging that the firm had deceptively omitted this information from its Item 303 filings.[98]

### 2. *The* Stratte-McClure *Court's Reading of* Oran *and* Cohen *and Ultimate Holding*

Similar to the district court's disposition in *Cohen*, the District Court for the Southern District of New York dismissed plaintiffs' suit for failure to state a claim.[99] In analyzing the issue on appeal, the court of appeals addressed—and offered a scathing rebuke of—the *Cohen* opinion's treatment of Item 303 omissions in the context of Rule 10b-5[100] actions.[101] Specifically, the *Stratte-McClure* court took issue with *Cohen*'s reading of *Oran v. Stafford*.[102] In its reasoning regarding the Item 303 liability issue, the Second Circuit relied on the similarities between Rule 10b-5 and other provisions of the securities laws.[103] The Second Circuit noted that it had already held that an Item 303 omission could form

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94 *Id.*

95 *Id.* at 97–98.

96 *Id.* at 97.

97 Brief and Special Appendix for Plaintiff-Appellant and Movant-Appellant at 20, Stratte-McClure v. Morgan Stanley, 776 F.3d 94 (2d Cir. 2015) (No. 13-0627-CV).

98 *Stratte-McClure*, 776 F.3d at 96.

99 *Id.*

100 Within the *Stratte-McClure* opinion's text, the court alternates between referencing Section 10(b) liability (the statutory text) and Rule 10b-5 liability (the regulatory liability). *Id.* at 96, 100–04, 106–08. Because Section 10(b) liability arises out of a violation of Rule 10b-5, *see* Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2012) (prohibiting the use of any manipulative or deceptive device in violation of the SEC's rules (including Rule 10b-5)), this Note simplifies the nomenclature by referring to Rule 10b-5 wherever possible.

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

102 *Id.*

103 *Id.* at 101–02.

the basis for a claim under Sections 11 and 12(a)[104] of the Securities Act of 1933.[105] The Second Circuit further noted that its likely treatment of Item 303 omissions under Rule 10b-5 had been foreshadowed in several previous decisions.[106] Bolstering its basis for analogizing to Section 12(a) liability, the Second Circuit noted that both Sections 12(a) and Rule 10b-5 require the disclosure of "material fact[s] necessary in order to make ... statements made ... not misleading."[107]

Having established its basis for including Item 303 disclosures within the realm of possible bases for Rule 10b-5 liability, the court proceeded to qualify its holding.[108] The court noted that the standards for Item 303 disclosure and the standards required by Rule 10b-5's materiality test differed significantly.[109] Moreover, the court, similar to its Third and Ninth Circuit counterparts, cautiously pointed out that the SEC itself noted that the material standards for Item 303 and Rule 10b-5 are "inapposite."[110] Ultimately, the Second Circuit laid down a simple test: Item 303 disclosures can only form a basis for Rule 10b-5 claims if they meet the higher materiality standard that already exists for omissions under that rule.[111]

Despite a difference in the legal reasoning—and antagonistic language—the Second Circuit came to the same conclusion as the Ninth Circuit in *Cohen*.[112] Although the court went to great lengths to establish that an Item 303 omission could satisfy the materiality standard under Rule 10b-5,[113] the Second Circuit still *upheld* the district court's dismissal.[114] This result means

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[104] *See* Securities Act of 1933, Pub. L. 73-22, §§ 11, 48 Stat. 74, 82–83 (1933) (codified as amended at 15 U.S.C. §77k (2012)) (regarding liability arising from registration statements); 15 U.S.C. § 77l(a) (regarding liability arising from prospectuses or oral communications).

[105] *Stratte-McClure*, 776 F.3d at 101–02.

[106] *Id.* at 102.

[107] *Id.* (internal quotations omitted).

[108] *Id.* at 102–03.

[109] *Id.* The same language was used in both of the previously discussed opinions. *See supra* notes 68–71, 89–91 and accompanying text.

[110] *Stratte-McClure*, 776 F.3d at 103.

[111] *Id.*

[112] *Id.* at 102–03.

[113] *Id.* at 100, 107–08.

[114] *Id.* at 100, 108.

that two circuit courts with factually similar scenarios coming to the same outcome have created a circuit court split in the process.

### *D. The District Court for the District of Minnesota*—Beaver County Employees' Retirement Fund v. Tile Shop Holdings, Inc.

Although *Beaver County Employees' Retirement Fund v. Tile Shop Holdings, Inc.* is not an appellate court decision, its facts and analysis are indicative of how subsequent district court decisions will handle the issue of Item 303 omissions.

#### *1. The Background to* Tile Shop

In *Tile Shop,* the district court was asked to rule on defendant's motion to dismiss the plaintiffs' claim that they had omitted material information from their Item 303 filing and, consequently, had violated Rule 10b-5.[115] The defendant corporation (Tile Shop) and its officers had been involved in several questionable dealings as a provider of stone and tile products.[116] The company failed to disclose its increasing reliance on certain trading partners.[117] Ultimately, an independent report detailed these relationships and noted that Tile Shop's earnings had been overstated as a result of the favorable dealings between these trading partners.[118] Consequently, Tile Shop's stock fell significantly.[119]

#### *2. The* Tile Shop *Court's Reading of* Oran*,* Cohen*, and* Stratte-McClure

The District Court for the District of Minnesota reviewed the approaches, reasoning, and readings of *Oran* presented by both the Second and the Ninth Circuits.[120] The court ultimately found the Second Circuit's reasoning more persuasive.[121] The *Tile Shop*

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[115] Beaver Cty. Emps.' Ret. Fund v. Tile Shop Holdings, Inc., 94 F. Supp. 3d 1035, 1044–48 (D. Minn. 2015).
[116] *Id.* at 1042–43.
[117] *Id.* at 1043–44.
[118] *Id.* at 1043.
[119] *Id.*
[120] *Id.* at 1047–48.
[121] *Id.* at 1047.

court believed that *Stratte-McClure* correctly read the standard outlined in *Oran*, and, accordingly, the *Tile Shop* court adopted the same standard for its own review.[122] The district court's opinion, however, differs importantly from the circuit court opinions noted above. The court, unlike those appellate decisions, upheld the Rule 10b-5 claim premised on an Item 303 omission.[123] That is, the court allowed the claim to survive the defendants' motions to dismiss.[124]

## III. Dispelling the Circuit Split Myth

Upon a basic understanding of the background and reasoning among the circuit courts, it is easy to assume that a circuit court split exists. After all, the Second Circuit and the District Court for the District of Minnesota both outright acknowledge the split.[125] Two important aspects of this circuit court divergence, however, cast light on the legitimacy of this "split."[126] First, it is not entirely clear that the Second Circuit's opinion on the issue is binding legal precedent.[127] Secondly, assuming, arguendo, that the pertinent language of the *Stratte-McClure* opinion was indeed a precedential holding, some doubt still remains about whether or not these holdings are wholly inconsistent and irreconcilable.[128]

### *A. The Second Circuit's Opinion on Item 303 Omissions May Be Non-Binding Dicta*

When this issue was filed with the Supreme Court in a petition for certiorari, the *Cohen* defendants' brief asserted that the *Stratte-McClure* opinion's discussion of Item 303's duty to disclose is nothing more than dicta.[129] A case usually is not treated

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[122] *Id.* at 1047–48.

[123] *Id.* at 1060–61.

[124] *Id.*

[125] Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 103 (2d Cir. 2015); *Tile Shop*, 94 F. Supp. 3d at 1047.

[126] The *Cohen* defendants briefed each of these aspects in opposition to the petition for writ of certiorari to the Supreme Court. Brief in Opposition at 12–17, Cohen v. NVIDIA Corp., 135 S. Ct. 2349 (2015) (No. 14-975) [hereinafter Brief in Opposition].

[127] *Id.* at 13.

[128] *Id.* at 13–15.

[129] *Id.* at 13.

as authority with regard to any point of law not necessary to decide the case or specifically raised before the court.[130] This contention, upon a cursory glance of the *Stratte-McClure* opinion, appears to be well founded. The plaintiffs' action in *Stratte-McClure* was, after all, dismissed on grounds of scienter, thus negating the need to discuss the materiality standard and the sufficiency of Item 303 omissions.[131] The *Cohen* defendants' Brief in Opposition also correctly notes that the Second Circuit itself has previously identified dicta as a statement that is "unnecessary to the decision in the case."[132]

Despite the arguments that the language in *Stratte-McClure* is largely dicta and non-binding, it is worth noting that there is equal authority to suggest that such a statement is binding on lower courts. The district courts within the Second Circuit have consistently held that pronouncements of the court of appeals that appear as dicta must be "regarded as the law of the Circuit, even though not ... a necessary step in the reasoning leading to a holding."[133] Moreover, a substantial line of cases already exists that tangentially allude to the possibility of Rule 10b-5 liability for Item 303 omissions within the Second Circuit.[134]

Most fatal to the argument that the Second Circuit's opinion lacks precedential value is the mere fact that the appellate court devoted so much time to directly address this specific point of law.[135] Despite the plaintiffs' failure to address the materiality

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[130] 20 AM. JUR. 2D *Courts* § 130 (2016) (citing Blue Cross and Blue Shield of Neb., Inc. v. Dailey, 687 N.W.2d 689 (Neb. 2004)).

[131] Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 104 (2d Cir. 2015). In fact, the court itself acknowledged that its discussion of Item 303 was unnecessary: "We assume, *arguendo*, that this [Item 303] omission was material under *Basic*. We nonetheless affirm the district court's dismissal of the claim[.]" *Id.*

[132] Brief in Opposition, *supra* note 126, at 13.

[133] United States v. Oshatz, 912 F.2d 534, 540 (2d Cir. 1990); *see also In re* Calvary Const., Inc., 496 B.R. 106 (S.D.N.Y. 2013); Patsy's Italian Rest., Inc. v. Banas, 508 F. Supp. 2d 194, 209 (E.D.N.Y. 2007).

[134] *Stratte-McClure*, 776 F.3d at 101 n.4; s*ee also In re* Scholastic Corp. Sec. Litig., 252 F.3d 63, 74 (2d Cir. 2001) (finding that Item 303 omissions could contribute to an adequately pled violation of Rule 10b-5); *In re* Corning, Inc. Sec. Litig., 349 F. Supp. 2d 698, 716 (S.D.N.Y. 2004) (noting that a district court must give Item 303 consideration when evaluating claims under Rule 10b-5).

[135] *Stratte-McClure*, 776 F.3d at 100–04.

issue in their appellate brief,[136] the Court of Appeals devoted nearly half of its discussion to commenting on the issue.[137] Given the importance attached to court of appeal's dicta in the Second Circuit and the amount of effort that the *Stratte-McClure* court spent reasoning and justifying its comments, it is unlikely that any district court within the Second Circuit would render a contrary ruling when faced with similar facts.

### *B. The Opinions of the Ninth and Second Circuit Courts of Appeals Can Be Harmonized into a Single, Coherent Holding*

Assuming, arguendo, that the *Stratte-McClure* opinion's ruling regarding Item 303 omissions is certain to persuade any district court faced with the same issue,[138] a convincing argument can be made that there is no significant difference in the treatment of the issue under *Stratte-McClure* and *Cohen*. In sum, the Second Circuit declared that its decision was contrary to the Ninth Circuit's opinion when, in reality, it was not.[139]

As the *Cohen* defendants' Brief in Opposition notes, a careful reading of both decisions reveals that the two opinions agree on several points.[140] First, both courts agree that disclosure requirements are broader under Item 303 than under *Basic's* requirement for Rule 10b-5.[141] Second, the opinions agree that an Item 303 omission does not automatically establish materiality under *Basic's* Rule 10b-5 standard.[142] Third, and most importantly, the

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[136] Plaintiffs' appeal fails to plead materiality according to the standards outlined in *Basic* and *Matrixx Initiatives*. *See generally* Brief and Special Appendix for Plaintiff-Appellant and Movant-Appellant, Stratte-McClure v. Morgan Stanley, No. 13-0627-CV (2d Cir. May 29, 2013).

[137] *Stratte-McClure*, 776 F.3d at 100–04.

[138] There can be little doubt that this would be the result of any subsequent Rule 10b-5 action premised on an Item 303 omission that satisfies the Court's *Basic* standard for materiality.

[139] *Stratte-McClure*, 776 F.3d at 103.

[140] Brief in Opposition, *supra* note 126, at 13–14.

[141] *Stratte-McClure*, 776 F.3d at 103 ("Item 303's disclosure obligations extend considerably beyond those required by Rule 10b-5.") (internal quotation marks omitted) (citing Oran v. Stafford, 226 F.3d 275, 288 (3d Cir. 2000)); Cohen v. NVIDIA Corp., 768 F.3d 1046, 1055 (9th Cir. 2014) ("Management's duty to disclose under Item 303 is much broader than what is required under ... *Basic*.").

[142] *Stratte-McClure*, 776 F.3d at 102, 103 ("The failure to make a required disclosure under Item 303 ... is not by itself sufficient to state a claim ... under [Rule 10b-5]."); *Cohen*, 768 F.3d at 1055 ("[T]he 'demonstration of a violation of the

opinions both conclude that a plaintiff must allege that the omission independently satisfies *Basic's* heightened standard in order to sustain a Rule 10b-5 action.[143]

Excluding the Second Circuit's critique of the *Cohen* opinion, the two opinions display only subtle differences in their approach to the question. Moreover, the two opinions' holdings are not contrary. Rather, they are complementary. A future district court could reasonably read the Ninth Circuit's opinion as considering whether an omission that satisfies Item 303's materiality standard imputes liability automatically under Rule 10b-5 without any further allegations.[144] The answer is, obviously, "no."[145] The same hypothetical district court could reasonably read the Second Circuit's opinion as considering whether an omission that satisfies both Item 303 and Rule 10b-5 materiality standards can support a Rule 10b-5 action.[146] The answer is "yes."[147] The two answers are not mutually exclusive. Both courts agree that an Item 303 omission that satisfies the lower Item 303 materiality standard but fails the higher Rule 10b-5 standard cannot carry the day on a motion to dismiss.[148]

Finally, the *Cohen* opinion still leaves open the question of whether an Item 303 disclosure could potentially form the basis of a Rule 10b-5 action.[149] Theoretically, a Ninth Circuit district court considering a motion to dismiss when an Item 303 omission

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disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5.'") (quoting Oran v. Stafford, 226 F.3d 275, 288 (3d Cir. 2000)).

[143] *Stratte-McClure*, 776 F.3d at 103 ("[P]laintiff must first allege that the defendant failed to comply with Item 303 .... [P]laintiff must then allege that the omitted information was material under *Basic's* ... test."); *Cohen*, 768 F.3d at 1056 (finding that plaintiffs could rely solely upon an Item 303 omission, but must also separately show materiality "according to the principles set forth by the Supreme Court in *Basic*.").

[144] *See Cohen*, 768 F.3d at 1056.

[145] *Id.*

[146] *See Stratte-McClure*, 776 F.3d at 103.

[147] *Id.*

[148] *Id.* ("[A] violation of Item 303's disclosure requirements can only sustain a claim under ... Rule 10b-5 if the allegedly omitted information satisfies *Basic's* test for materiality."); *Cohen*, 768 F.3d at 1056 ("[A] duty to disclose [under Rule 10b-5] must be separately shown according to the principles set forth by the Supreme Court in *Basic*[.]").

[149] *See Cohen*, 768 F.3d at 1054–56 (failing to state that an Item 303 omission could not form the basis of a Rule 10b-5 disclosure; instead, merely stating that Item 303 by itself does not create a duty under Rule 10b-5).

has been properly plead to simultaneously satisfy both the Item 303 materiality standard[150] and the higher Rule 10b-5 standard as laid out in *Basic*[151] would not be required to dismiss the case because of the *Cohen* precedent[152]—nor would the Ninth Circuit Court of Appeals be bound to overrule such a dismissal on appeal.

## IV. Policy Considerations in Favor of the Harmonized Reading

### *A. The Harmonized Reading Increases Market Accuracy*

When traders are given more quality information regarding a certain stock, they are better able to effectively establish a security's actual value.[153] Traders do this out of a belief that current stock prices are inherently incorrect—that is, they cannot reflect *all* available information.[154] While the ultimate motive for any investigation is almost certainly personal profit,[155] the tangential benefits that accrue to the market from accurate pricing are important.[156]

It is generally believed that markets and society in general are better off when stock prices more accurately reflect their true value.[157] More specifically, the more accurately a security's price reflects its true value, the more efficient society's allocation of resources becomes.[158] It has been argued that increasingly accurate stock prices allow investors to more effectively identify and select those corporations with superior prospects.[159]

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[150] That is, the "trend, demand, commitment, event or uncertainty" is likely to come to fruition, or a determination cannot be made and will likely have a material effect on the corporation's financial condition or results of operations. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22,427, 22,430 (May 24, 1989).

[151] That is, the forward-looking statement is material after balancing the likelihood that it will come to fruition and the anticipated magnitude of its impact. *See* Basic v. Levinson, 485 U.S. 224, 238 (1988).

[152] *Cohen*, 768 F.3d at 1054–55.

[153] Kevin Haeberle, *Stock-Market Law and the Accuracy of Public Companies' Stock Prices*, 2015 COLUM. BUS. L. REV. 121, 132 (2015).

[154] *Id.* at 131–32.

[155] *Id.* at 132–33.

[156] *Id.* at 133–34.

[157] *Id.* at 123–24.

[158] *Id.*

[159] *Id.* at 137.

Conversely, increasingly inaccurate markets lead to a poorer allocation of resources.[160] In this sense, market accuracy cuts as a double-edged sword, simultaneously allocating resources to high-potential corporations while diverting them away from low-potential corporations.[161]

The harmonized reading would incentivize firms to take a more cautious approach to their Item 303 filings—favoring over-inclusive disclosure of potentially material information. These increased disclosures would allow markets to maintain a high level of accuracy[162] and, thus, prevent the ignorant, inefficient allocation of resources to firms with serious flaws. As an illustration, in *Oran*, *Cohen*, *Stratte-McClure*, and *Tile Shop*, each of the four plaintiffs argued that the respective defendant-corporations' stock did not accurately reflect the risks associated with its purchase.[163] If investors had had access to information regarding the various faults of these firms through a complete Item 303 disclosure, then their knowledge would have likely affected the price of the respective corporations' stocks. Armed with an accurate price and increased knowledge, the market would have reacted by reallocating resources away from suboptimal firms and into those which carried less risk.

### *B. PSLRA Protections Prevent Meritless Strike-Suits Under the Harmonized Reading*

While proponents of disclosure often tout the "market accuracy" argument,[164] many scholars who oppose this view argue with

[160] *Id.* at 137–38.

[161] *Id.* at 137.

[162] *See id.* at 126, 182.

[163] In *Oran*, the stock price allegedly was an inaccurate reflection of the risk associated with the pharmaceutical's side effects. *See* Oran v. Stafford, 226 F.3d 275, 283 (3d Cir. 2000). In *Cohen*, the stock price did not accurately reflect the risk associated with the faulty solder. *See* Cohen v. NVIDIA Corp., 768 F.3d 1046, 1048, 1050–51 (9th Cir. 2014). In *Stratte-McClure* the stock price did not accurately reflect the risk associated with an extensive exposure to the credit-default market. *See* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 98, 104 (2d Cir. 2015). In *Tile Shop*, the stock price did not accurately reflect the truth behind the source of the corporation's profit margins. *See* Beaver Cty. Emps.' Ret. Fund v. Tile Shop Holdings, Inc., 94 F. Supp. 3d 1035, 1050–52 (D. Minn. 2015).

[164] *See generally* Merritt B. Fox, *Required Disclosure and Corporate Governance*, LAW & CONTEMP. LEGAL PROBS., Summer 1999, at 113 (noting the

equal voracity; they argue that securities laws have gone too far and have caused an enormous amount of baseless strike suits to the benefit of plaintiffs' attorneys alone.[165] Many look no further than the skyrocketing cost of defending class action securities fraud lawsuits.[166] From this viewpoint, Item 303 omissions may seem to be a frightening new arrow in the class action plaintiff's quiver.

To give corporations some additional protection from the onslaught of private class action lawsuits under Rule 10b-5, Congress enacted the Private Securities Litigation Reform Act (PSLRA) in 1996.[167] The PSLRA—in conjunction with the Federal Rules of Civil Procedure[168]—raises the standard for a private securities action to survive a motion to dismiss.[169] Per these requirements, plaintiffs who wish to premise a Rule 10b-5 action on a material omission—such as an Item 303 omission under the harmonized reading of *Cohen* and *Stratte-McClure*—must plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[170] The most important wrinkle to this heightened requirement is that a plaintiff must overcome this hurdle before proceeding with discovery.[171] A plaintiff, therefore, without access to discovery tools such as depositions or document production, must state particularized facts regarding board room discussions or decisions about SEC filings (e.g., Item 303)—a difficult task.[172]

Under the harmonized reading, however, the materiality prong of the PSLRA's "safe harbor" provisions still applies to

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benefits of increased accuracy that result directly from increased disclosure in the context of share price and the market for corporate control).

[165] *See generally* ANDREW J. PINCUS, U.S. CHAMBER INST. FOR LEGAL REFORM, WHAT'S WRONG WITH SECURITIES CLASS ACTION LAWSUITS: THE COST TO INVESTORS OF TODAY'S PRIVATE SECURITIES CLASS ACTION SYSTEM FAR OUTWEIGHS ANY BENEFITS (2014), http://www.instituteforlegalreform.com/uploads/sites/1/Securities_Class_Actions_Final1.pdf [https://perma.cc/BUA9-5TET].

[166] *Id.* at 6 (noting that legal fees for such suits can run into the hundreds of millions of dollars).

[167] BLOOMENTHAL & WOLF, *supra* note 45, § 27:11.

[168] Federal Rule of Civil Procedure Nine requires plaintiffs to plead the circumstances surrounding allegations of fraud with "particularity." Fed. R. Civ. P. 9(b).

[169] *See* BLOOMENTHAL &WOLF, *supra* note 45, § 29:1–2.

[170] 15 U.S.C. § 78u-4(b)(2) (2012).

[171] BLOOMENTHAL & WOLF, *supra* note 45, § 29:1.

[172] *See id.*

defendants facing allegations of violating Rule 10b-5 for Item 303 omissions. As discussed above, Item 303 omissions would still need to satisfy the *Basic* standard of materiality.[173] In fact, in *Stratte-McClure* and *Cohen*, the plaintiffs' claims failed because they did not adequately plead scienter.[174] Under the harmonized reading, Item 303 omissions would become "fair game," and yet, the same set of rules, including all the difficulties in pleading scienter relating to forward-looking statements, would apply.

## CONCLUSION

The "judicial oak" of Rule 10b-5 private actions has had a turbulent and interesting history. When the Second Circuit Court of Appeals announced a split with its sister court in the Ninth Circuit, a reaction was expected and natural. In this case, the split may have been more mole hill than mountain.

Upon a closer look, the Second Circuit and the Ninth Circuit based their decisions upon similar readings of the same cases. Moreover, the Second Circuit's basis for its claim that their *Stratte-McClure* comments are "at odds with" the Ninth Circuit's holding in *Cohen* is unclear.[175] The Second Circuit's criticism of *Cohen* and analysis of *Oran* were apparently persuasive enough to convince the District Court in Minnesota to agree with the court and (supposedly) disagree with the Ninth Circuit.[176]

No matter how persuasive the Second Circuit's reasoning, however, it is clear that harmonizing the holdings in *Stratte-McClure* and *Cohen* into a single coherent legal principle does not stretch the limits of logical possibility.[177] The Second, Third, and Ninth Circuits agree that the standards for Item 303's disclosure requirement and a claim of securities fraud under the Rule 10b-5

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[173] *See supra* Part III.B.

[174] Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 104 (2d Cir. 2015) (assuming that the omission was material, yet failing to find scienter pled adequately); Cohen v. NVIDIA Corp., 768 F.3d 1046, 1065 (9th Cir. 2014) (commenting that plaintiffs not only failed to plead materiality but also failed to plead scienter).

[175] *Stratte-McClure*, 776 F.3d at 103.

[176] Beaver City Emps.' Ret. Fund v. Tile Shop Holdings, Inc., 94 F. Supp. 3d 1035, 1047 (D. Minn. 2015).

[177] *See supra* Part IV.

differ significantly.[178] The courts also agree that information that is required on Item 303 requires something more to give rise to Rule 10b-5 liability.[179] It seems that this is merely the story of a circuit court split that simply never existed—but created quite a stir nonetheless.

[178] *Stratte-McClure*, 776 F.3d at 102–03; *Cohen,* 768 F.3d at 1055; Oran v. Stafford, 226 F.3d 275, 288 (3d Cir. 2000).

[179] *Stratte-McClure*, 776 F.3d at 103–04; *Cohen*, 768 F.3d at 1055–56; *Oran*, 768 F.3d at 288 (quoting Alfus v. Pyramid Tech. Corp., 764 F. Supp. 598, 608 (N.D. Cal. 1991)).