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A Newsletter from Chicago Underwriting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

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In this issue ... *a brief refresher on key elements of the 1933 and 1934 federal Securities Acts, corresponding SEC regulatory framework, and how a recent case that revolved around the 1934 Act and the SEC regulations may pose new challenges for publicly-held companies.*

FEDERAL SECURITIES LAWS: 1933 AND 1934

Still highly pertinent more than 80 years after their enactment, the Securities Act of 1933 (the 1933 Act), and the Securities Exchange Act of 1934 (the 1934 Act) are the touchstone for federal securities litigation.

In general, the 1933 Act is concerned with regulating and policing the initial issuance and distribution of securities, while the 1934 Act has broader scope and regulates all aspects of public securities trading.

Both Acts provide for investors to have private rights of action; in other words both Acts permit private parties to sue the directors and officers of companies that have issued stock under the Acts. Such companies are sometimes referred to "issuers."

THE 1933 ACT

For securities litigation, the most relevant part of the 1933 Act, and a frequent basis for securities class action (SCA) lawsuits, is Section 11: "Civil Liabilities on Account of False Registration Statement." Under subsection (a), a shareholder is generally given the green light to sue, "In case any part of the registration statement, when such part became effective, 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… ."

Who may be sued? Subsections (a) (1) through (a) (5) spell out the possible targets, including every person who signed the registration statement, as well as any directors, accountants, and underwriters at the time the statement was issued. The broad sweep of this section imposes potentially significant liabilities on corporate directors, with the goal of forcing the directors to ensure the accuracy of registration statements. Liability of corporate officers, however, is generally limited to those that signed the registration statement. Allegations of fraud are usually not required in order to establish a claim under Section 11.

THE 1934 ACT

Section 10(b) of the 1934 Act is the umbrella under which most SCA lawsuits are filed. In contrast to Section 11 of the 1933 Act, Section 10(b) of the 1934 Act is very much an anti-fraud provision, and so claims brought under this section must involve allegations of fraud. Here is part of section 10 of the 1934 Act:

Regulation of the Use of Manipulative and Deceptive Devices

SEC. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange …

(b) To 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 in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The U.S. Supreme Court, in its role as interpreter of legislation, has held that plaintiffs trying to allege liability under Section 10 (b) must show intent by the defendants to deceive or defraud. This intent is typically referred to as acting "with *scienter*," using a Latin term in a phrase that roughly means "knowingly."

THE ROLE OF THE SEC

Complementing the securities laws is the work of the Securities and Exchange Commission (SEC), which is charged with practical implementation of the statutes, overseeing compliance with them, and using its enforcement powers where appropriate. In that role, the SEC is authorized to develop rules and regulations in order to clarify the federal acts. The SEC then monitors compliance with the laws, using its enforcement powers where appropriate. The SEC rules and regulations created to support the 1933 and 1934 federal securities laws are extensive. We will look at just a couple of the more relevant ones.

SEC Rule 10(b)-5

Numbered to reflect the part of the 1934 Act that it addresses, and using language that generally tracks that of the act, SEC Rule 10(b)-5 is worth quoting in full:

§240.10b-5: Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) 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, or operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

In a 1969 case, the U.S. Supreme Court commented that between them, Section 10(b) and Rule 10(b)-5 might "well be the most litigated provisions in the federal securities laws."

SEC Regulation S-K, Item 303

Regulation S-K is generally concerned with the requirements applicable to the content of the non-financial statement portions of registration statements, and documents required to be filed with the SEC under the federal Securities Acts; in other words the language used rather than the numbers stated.

Section 229.303 —typically known as Item 303— addresses an issuer's "management discussion and analysis of financial condition and results of operations," with guidance on the topics that need to be covered, if applicable. Subsection (2)(i) reads in part:

> *Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and relative cost of such resources.*

Regulation S-K in general, and this subsection in particular, are therefore subjective in nature, inviting company executives to comment on matters they have identified as germane and of importance to investors, or to use a word potentially loaded with ramifications: "material" matters.

STRATTE-MCCLURE V. MORGAN STANLEY: A SPLIT BETWEEN CIRCUITS

A vivid example of how securities litigation is typically founded on a combination of federal laws and SEC regulations was recently demonstrated in a January 12, 2015 decision by the U.S. Court of Appeals for the 2nd Circuit in the case of *Stratte-McClure v. Morgan Stanley*. The court held that a company's failure to comply with the management disclosure and analysis requirements in Item 303 of Regulation S-K may provide plaintiffs with a basis for a securities fraud claim under Section 10(b) of the 1934 Securities Exchange Act.

Morgan Stanley had taken some complex trading positions relating to credit-default swaps tied to collateralized debt obligations that were backed by subprime residential mortgage-backed securities. These positions deteriorated significantly during 2007, and plaintiffs alleged that by failing to disclose in its Form 10-Q the possible impact on revenue as dictated by S-K Item 303, Morgan Stanley had a committed a violation of both Section 10(b) of the 1934 Act, and of SEC Rule 10(b)-5.

The court agreed: "Failure to make a required Item 303 disclosure in a 10-Q filing is indeed an omission that can serve as a basis for a Section 10(b) securities fraud claim." This seemingly innocuous statement reverberated around the world of securities-law practitioners.

Less than six months earlier, in October 2014, the Court of Appeals for the 9th Circuit had concluded the opposite: "Item 303's disclosure duty is *not* actionable under Section 10(b) and Rule 10b-5." [emphasis added] With such a clear conflict between the Second Circuit and Ninth Circuit, there is a general belief that the issue will eventually be taken up by the U.S. Supreme Court to resolve the split. Corporate lawyers are advising their publicly-listed clients to pay particular attention to describing industry trends and uncertainties in their filed documents: There is general agreement that the Stratte-McClure decision has raised the bar for disclosure duties. ❖

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Chicago Underwriting Group:
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