Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—U.S.: Inadequate Item 303 disclosure may serve as basis for 10(b) liability, cert petition argues, (Feb. 13, 2015)

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By Amy Leisinger, J.D.

An investor has petitioned the U.S. Supreme Court to resolve a question as to whether Item 303 of Regulation S-K can form the basis of a duty to disclose material information for the purposes of liability under Exchange Act Section 10(b) and Rule 10b-5. According to the petitioner, the Ninth Circuit's holding affirming dismissal of his fraud action conflicts with other circuits' decisions finding that a regulation can give rise to a duty to disclose material information under the Exchange Act, and the Court should grant certiorari to prevent the nullification of federal regulations resulting from the Ninth Circuit's determination (*Cohen v. NVDIA Corp.*, February 9, 2015).

Background. In 2008, NVDIA Corp., a publicly traded semiconductor company, disclosed information to investors about defects in two of its products and later stated that it would take a $150-$200 million charge to cover costs. NVIDIA's share price thereafter dropped 31 percent. Between November 2007 and May 2008, NVIDIA filed several forms with the SEC routinely including a statement explaining that "[its] products may contain defects or flaws," and warning investors that "[it] may be required to reimburse customers for costs to repair or replace the affected products."

In their complaint, the plaintiffs alleged that NVIDIA knew of and should have informed investors of product defects earlier and that, absent such a disclosure, the company's intervening statements were misleading to investors. The district court dismissed the complaint, specifically holding that the plaintiffs failed to sufficiently plead scienter.

A Ninth Circuit panel affirmed a district court's dismissal of a securities fraud action against NVIDIA Corporation and other defendants under Exchange Act Sections 10(b) and 20(a) and Rule 10b-5. In its opinion (covered in the *Securities Regulation Daily Wrap Up* for October 2, 2014), the panel stated that the plaintiffs failed adequately to allege facts giving rise to a strong inference of scienter. The panel rejected the plaintiffs' argument that the district court erred by failing to consider their allegations of scienter in the context of Item 303 of Regulation S-K, which requires disclosure of information concerning known trends or uncertainties reasonably expected to have an impact on financial performance. The court found that Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5. "Because the materiality standards for Rule 10b-5 and [Item 303] differ significantly, 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,'" the court explained.

Petition for certiorari. According to the petitioner, failure to make adequate disclosures under Item 303 can provide the basis for a material omission for a claim under Section 10(b) and Rule 10b-5. The Ninth Circuit's conclusion that Item 303 does not create a duty to disclose for Section 10(b) purposes conflicts with the determinations of other circuits, the petitioner explains, noting that both the Second and Third Circuits have found that an Item 303 violation can establish an actionable omission under Section 10(b) if the information is material and other elements of a fraud claim are present. These courts recognize an affirmative duty to disclose when a statute or regulation requires disclosure, according the petitioner, and the precedent cited by the Ninth Circuit only says that an Item 303 violation does not "automatically give rise to a material omission."

The petitioner also contends that the Ninth Circuit's decision undermines the SEC's rulemaking authority by hindering enforcement and protecting those committing disclosure failures from liability under federal regulations. "The civil enforceability of those rules and regulations is essential to realizing the central goal underlying the disclosure provisions of the securities markets," the petitioner explains.

The case is No. 14-975.

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