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Securities Regulation

by David K. Brown[*]
and Derek B. Swanson[**]

This Article examines significant cases originating in the United States Court of Appeals for the Eleventh Circuit during 2012 and 2013 under the Securities Act of 1933 (the Securities Act or 1933 Act),[1] the Securities Exchange Act of 1934 (the Exchange Act or 1934 Act),[2] and the rules promulgated thereunder. In particular, Part I of this Article addresses a recent decision involving alleged material misstatements in connection with an initial public offering. Part II analyzes a recent case addressing the loss-causation element of a claim of fraud under United States securities law, namely, under § 10(b)[3] of the Exchange Act and Exchange Act Rule 10b-5 (Rule 10b-5).[4] Finally, Part III surveys two recent cases involving the materiality element in the Securities and Exchange Commission (SEC) enforcement cases involving alleged violations of § 10(b) and Rule 10b-5.

As reflected in the cases discussed below, when it comes to a private right of action under the Securities Act and the antifraud provisions of the Exchange Act, plaintiffs face some difficult hurdles in successfully pleading a cause of action that can withstand a motion to dismiss. With respect to private rights of action under the Securities Act, as discussed in Part I of this Article, plaintiffs face an uphill battle in successfully

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1. 15 U.S.C. §§ 77a-77aa (2012).
2. 15 U.S.C. §§ 78a-78pp (2012).
3. 15 U.S.C. § 78j (2012).
4. 17 C.F.R. § 240.10b-5 (2013).

arguing that disclosures in a registration statement and prospectus were materially misleading (or contained a material omission), especially where the disclosure document is well-drafted and structured to anticipate potential risks in investing in the company's securities. With respect to private rights of action under § 10(b) and Rule 10b-5 under the Exchange Act, as discussed in Part II of this Article, plaintiffs face the difficult task of successfully pleading the loss-causation element, especially where the fraud-on-the-market theory is asserted. Finally, as discussed in Part III of this Article, the court of appeals has provided the SEC with limited latitude in showing materiality of a misstatement, and while favorable to the SEC in this particular case, the court's extension of the reliance test to enforcement actions could raise the bar for the SEC.

I. THE ELEVENTH CIRCUIT ADDRESSES CLAIMS OF MATERIAL MISSTATEMENTS IN A REGISTRATION STATEMENT AND PROSPECTUS UNDER THE SECURITIES ACT

In a recent case involving an initial public offering that was conducted after the "Great Recession" of 2008, the Eleventh Circuit concluded that alleged misstatements or omissions in the registration statement and related prospectus were not material.[5] In so holding, the Eleventh Circuit illustrated the importance of well-drafted offering documents that include ample risk-factor coverage and other meaningful cautionary language. The case also demonstrates the important distinction between facts that are material because they significantly alter the total mix of information required to be disclosed to investors and facts that are not material even though they are viewed within the company as important.

A. *Antifraud Claims under § 11 and § 12(a)(2) of the Securities Act*

In *Miyahira v. Vitacost.com, Inc.*,[6] the investor-plaintiffs claimed that the defendant-appellees, including the issuer of the securities (Vitacost), made material misstatements and omissions in the offering documents for Vitacost's initial public offering (IPO).[7] In marshalling these arguments, the investors claimed that Vitacost and the other defendants had violated § 11[8] of the Securities Act and § 12(a)(2)[9] of the Securities

5. Miyahira v. Vitacost.com, Inc., 715 F.3d 1257, 1266 (11th Cir. 2013).
6. 715 F.3d 1257 (11th Cir. 2013).
7. *Id.* at 1260.
8. 15 U.S.C. § 77k(a) (2012). The relevant excerpt of § 11 of the Securities Act reads as follows:

> (a) Persons possessing cause of action; persons liable

Act; the relevant sections of which are quoted in the endnotes following this Article.[10]

Section 11 of the Securities Act creates a private right of action where a registration statement filed under the 1933 Act (including the prospectus contained therein), "contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated [in the registration statement] or necessary to make the statements therein

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> 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, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—
>
> (1) every person who signed the registration statement;
>
> (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
>
> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
>
> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
>
> (5) every underwriter with respect to such security.

15 U.S.C. § 77k(a).

9. Section 12(a)(2) of the Securities Act reads as follows:

> (a) In general
>
> Any person who— . . . offers or sells a security (whether or not exempted by the provisions of [§ 3], other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77l(a)(2) (2012).

10. *Miyahira*, 715 F.3d at 1264.

not misleading."[11] Section 12(a)(2) also creates a similar private right of action with respect to any material misstatements or omissions in any prospectus or oral communication used to solicit the sale of a registered security.[12] Thus, under both causes of action, a plaintiff must prove: "(1) the prospectus contained an omission; (2) the omission was material; (3) [the defendants] had a duty to disclose the material information; and (4) the information existed at the time the prospectus became effective."[13]

Whereas a claim under § 11 may be made only against the issuer of the securities, the issuer's directors, anyone who signed the 1933 Act registration statement, the underwriters of the offering, and any accountants or other experts who have been named (and consented to such disclosure) in the registration statement, a claim under § 12(a)(2) may be made against any person who sells a security (not just the person who transfers title to the security), including anyone who "successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner."[14] Under both § 11 and § 12(a)(2), there is no scienter requirement.[15]

B. *Miyahira v. Vitacost.com, Inc.*

1. Disclosure in Prospectus. In September 2009, Vitacost filed its prospectus (after its 1933 Act registration statement was declared effective) to offer and sell its securities to the public in an IPO. In the prospectus, Vitacost included biographies for its officers and directors, including Wayne Gorsek, the founder and Chief Operations Architect, and Eigerwand Bjornstad, the company's Vice President of Manufacturing. The disclosure in the prospectus stated that, because of a prior action by the SEC, Gorsek did not exercise policy-making authority and if Vitacost permitted him to do so the NASDAQ Stock Market (the

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11. *Id.* at 1265 (quoting 15 U.S.C. § 77k(a)).

12. *Id.*

13. *Id.* at 1266 (citing Oxford Asset Mgmt., Ltd. v. Jaharis, 297 F.3d 1182, 1189 (11th Cir. 2002)).

14. *See* Pinter v. Dahl, 486 U.S. 622, 647 (1988). In that decision, the United States Supreme Court refused to extend liability to (1) gratuitous sellers who urge the purchase of the securities out of a desire to benefit the prospective buyer or (2) participants only remotely related to the relevant aspects of the sales transaction, such as accountants and lawyers whose involvement is only the performance of their professional services. *Id.* at 647, 651-52.

15. A necessary element in virtually any action for fraud, whether under the securities laws or under state tort laws, is scienter, which is the intent to deceive, manipulate, or defraud.

market on which Vitacost was seeking to have its shares quoted in connection with the IPO) could delist Vitacost's shares. The prospectus also included risk-factor disclosure regarding the departure of key personnel but did not disclose that any key personnel (including Gorsek and Bjornstad) would be leaving Vitacost shortly after the IPO.[16]

In addition, the prospectus included disclosure regarding Vitacost's anticipated need, within the next twelve to eighteen months, to secure additional space for its distribution platform and, within approximately six months thereafter, the need to secure additional space to expand the company's manufacturing capabilities.[17] The prospectus, however, also included risk-factor disclosure regarding "difficulty expanding our manufacturing and distribution facilities" and "disruptions in our manufacturing system."[18]

Finally, the prospectus included extensive disclosure regarding FDA regulations applicable to the company, as well as specific risk factors related to FDA regulations. In particular, the prospectus disclosed that the FDA may determine that certain advertising and promotional claims are not in compliance with applicable laws and regulations.[19]

2. **Pre- and Post-IPO Facts.** Though not disclosed in the prospectus, prior to the IPO, the CEO of Vitacost had informed a confidential witness that "Gorsek and Bjornstad were 'short timers' who would soon be gone from Vitacost," and that the CEO "planned to terminate Bjornstad as soon as Vitacost reported its [third quarter of 2009] numbers;"[20] this was important because, as confirmed by numerous confidential witnesses, Bjornstad was "largely responsible for building Vitacost's manufacturing operation into a success."[21] In addition, several months prior to the IPO, Vitacost's management had decided to relocate its west-coast distribution center and had begun searching for new space for the relocation.[22]

Shortly after the IPO, in December 2009, the CEO of Vitacost forced Gorsek out of the company and terminated Bjornstad's employment. In the same month, Vitacost managers were summoned to the FDA's

16. The key portion of the risk-factor statement read: "Our success depends to a significant degree upon the continued contributions of our executive officers and other key personnel." *Miyahira*, 715 F.3d at 1262 (quoting prospectus).

17. *Id.*

18. *Id.* at 1263 (quoting prospectus).

19. *Id.*

20. *Id.* at 1261 (quoting the record). As noted above, the IPO commenced in September 2009, just prior to the end of the third quarter of 2009.

21. *Id.* (quoting the record).

22. *Id.* at 1260-61.

regional office, which resulted in Vitacost being forced to remove and change certain product labels that made prohibited health claims; these violations were similar to violations (for other products) that Vitacost committed in 2005. Finally, in November 2009, the company filed an 8-K disclosing that it had entered into a lease for a new distribution facility in Las Vegas; a lease that had an effective date of September 30, 2009 (a few days after the IPO).[23]

3. Analysis of Materiality of Alleged Misstatements in Prospectus. Beginning first with the terminations of Gorsek and Bjornstad shortly after the IPO, the Eleventh Circuit addressed the plaintiffs' argument that the prospectus contained a material omission by not disclosing that the company's CEO intended to fire these executives after the IPO.[24] While plaintiffs demonstrated that numerous personnel within the company viewed these executives as vital to the success of the company, the court determined that this focus was "misguided"; what matters to the analysis was "whether, given the information required to be provided to investors before the IPO, investors would have viewed Gorsek and Bjornstad's impending departures as material to their investment decision."[25]

When viewed under this lens, the court determined that the alleged misstatements regarding Gorsek and Bjornstad were not material.[26] It was clearly disclosed in the prospectus that Gorsek's policy-making role was limited because of a prior SEC enforcement action.[27] As a result, the court held that "no reasonable investor could have viewed his departure as significantly altering the total mix of information available."[28] Furthermore, with respect to Bjornstad, because there was nothing in the prospectus suggesting that his continued employment was critical to the success of the company, "investors had no reason to think that without him the company would not continue to be successful."[29]

Interestingly, the Eleventh Circuit did not address the question of whether Vitacost was required to disclose, in its risk factors or elsewhere, that the continued employment of Bjornstad was vital to its success. In addition, the court did not address the fact that the risk factor regarding the departure of "executive officers" and other key

23. *Id.* at 1263-64.
24. *Id.* at 1266.
25. *Id.* at 1266-67.
26. *Id.* at 1267.
27. *Id.*
28. *Id.*
29. *Id.*

personnel would presumably apply to the departure of Bjornstad; the company had already disclosed the importance of the departure of any executive officers (including Bjornstad) to its continued success.[30] Therefore, Bjornstad's departure could have reasonably been viewed by an investor as significantly altering the total mix of information.

The Eleventh Circuit next addressed the plaintiffs' arguments that Vitacost's disclosure regarding its new distribution facility and violations of FDA regulations were materially misleading.[31] The court quickly dispensed with the FDA regulatory disclosure by pointing out that the plaintiffs' allegations attempted to link a prior violation of FDA regulations (from 2005) to a violation of similar regulations for completely different products.[32] As stated by the court, the plaintiffs' allegation seemed to be that "by virtue of being notified that four specific products needed to be re-labeled in 2005, Vitacost had knowledge that it was not in compliance with regard to other, unrelated products in 2009."[33]

As to the allegations of material misstatements surrounding the company's new distribution facility, the court viewed the company's risk-factor disclosure regarding its expectation that it would need to relocate its distribution facilities within the next twelve to eighteen months as having successfully staved the plaintiffs' allegations of a material misstatement.[34] All that had been proven, the court held, was that Vitacost had begun looking for a new space for its distribution facility.[35] Without an allegation that either Vitacost knew it "would locate, or had already located, a new facility and when the relocation would occur, there [was] nothing false or misleading about the prospectus."[36]

4. Lessons from *Miyahira*. If there is one lesson that can be gleaned from the *Miyahira* decision, it is the importance of a well-drafted disclosure document for a public offering of securities. Despite the fact that the plaintiffs had marshalled evidence that Vitacost's management knew, before commencement of the IPO, that it was planning on relocating its distribution facilities and that two of its executive officers would be terminated, the Eleventh Circuit viewed these facts as, at most, sufficient to show that there were immaterial

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30. *Id.* at 1262 (quoting prospectus) ("Our success depends to a significant degree upon the coninued contributions of our executive officers . . . .").

31. *Id.* at 1267.

32. *Id.* at 1267-68.

33. *Id.*

34. *Id.* at 1267.

35. *Id.*

36. *Id.*

misstatements in the prospectus.[37] The court focused on the disclosure required in the document itself and determined that because of the existing disclosures in the prospectus, the omitted facts were not material in light of what was required to be disclosed.[38]

II. THE ELEVENTH CIRCUIT ADDRESSES LOSS CAUSATION UNDER SECTION 10(B) OF THE EXCHANGE ACT

While having a prominent hedge fund investor publicly prognosticate on the low value of your stock and questionable accounting policies and having to tell the market that you face an SEC investigation is an unenviable position for any public company, can it be the basis for loss causation in a securities fraud claim? That is the question the Eleventh Circuit faced in *Meyer v. Greene*.[39]

In *Meyer*, the plaintiffs in a consolidated class action alleged that St. Joe Company had violated §§ 10(b) and 20(a)[40] of the Exchange Act and Rule 10b-5.[41] The United States District Court for the Northern District of Florida dismissed the claim for failing to plead loss causation, actionable misrepresentation, and scienter. The plaintiffs appealed the district court's ruling.[42]

The allegations originated from St. Joe's financial statements and the manner in which St. Joe valued its assets. From its early beginnings in the 1930s, St. Joe had amassed a considerable real estate holding in Florida. St. Joe used this land primarily for residential, commercial, and industrial development, as well as raw land sales and timber cultivation. This real estate appreciated in value considerably during the early 2000s,[43] and the carrying value of this land as shown on the company's balance sheet reflected this appreciation—as of December 31, 2007, a total investment value of $943,540,000.[44] However, while St. Joe and its real estate portfolio was not immune to the real estate downturn in 2008, St. Joe nonetheless continued to show the carrying value of its real estate at pre-recession highs.[45]

37. *See id.*

38. *Id.* Underlying the court's discussion appears to be an assumption that the disclosure document was fully compliant with the disclosure requirements under the Securities Act.

39. 710 F.3d 1189 (11th Cir. 2013).

40. 15 U.S.C. § 78t (2012).

41. *Meyer*, 710 F.3d at 1192.

42. *Id.*

43. *Id.*

44. ST. JOE COMPANY, ANNUAL REPORT (FORM 10-K) 24 (FEB. 21, 2008) *available at* http://www.sec.gov/Archives/edgar/data/745308/000095013508001146/b68110sje10vk.htm>.

45. *Meyer*, 710 F.3d at 1192.

On October 13, 2010, prominent hedge fund investor David Einhorn publicly challenged St. Joe's carrying value for its real estate assets, asserting that this value was artificially inflated and thus should be "impaired"—that is, the value should be written down to a much lower amount. Within two days following Einhorn's statement, the market value of St. Joe's stock decreased by twenty percent. On November 3, 2010, the plaintiffs filed their complaint alleging St. Joe violated securities laws by failing to reduce the carrying value of its real estate. The district court dismissed the case and the plaintiffs appealed to the Eleventh Circuit.[46]

The Eleventh Circuit applied the precedent that, for any private cause of action under § 10(b) and Rule 10b-5, the plaintiff must plead

> (1) a material misrepresentation or omission; (2) scienter—a wrongful state of mind; (3) a connection between the misrepresentation and the purchase or sale of a security; (4) reliance, "often referred to in [fraud-on-the-market cases] as transaction causation;" (5) economic loss; and (6) "loss causation, i.e., a causal connection between the material misrepresentation and the loss."[47]

The court first analyzed the reliance element of the § 10(b) and Rule 10b-5 claim, discussing the traditional showing of reliance (which requires that the plaintiff was aware of the misstatement and purchased stock based upon that misrepresentation) in comparison to the fraud-on-the-market theory (which assumes that the price of publicly traded shares reflects all publicly available information, including misstatements, and thus provides a rebuttable presumption that purchasers rely on all public statements—and misstatements—when purchasing securities at the market price).[48] The court seemingly accepted the plaintiffs' use of the fraud-on-the-market theory to establish their prima facie case.[49] However, in a twist of fate, the court's acceptance of this principle was the death knell to the plaintiffs' securities-fraud claim, for it effectively precluded the plaintiffs from successfully proving another necessary element of a claim of securities fraud—loss causation.[50]

In a § 10(b) claim, the plaintiff must prove loss causation, that is, "proof of a causal connection between the misrepresentation and the investment's subsequent decline in value,"[51] in essence showing "not only that a fraudulent misrepresentation artificially inflated the

46. *Id.* at 1193.
47. *Id.* at 1194 (quoting Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005).
48. *Id.* at 1194-95.
49. *Id.* at 1195.
50. *Id.*
51. *Id.* (quoting Robbins v. Koger Props., Inc., 116 F.3d 1441, 1448 (11th Cir. 1997)).

security's value, but also that 'the fraud-induced inflation that was baked into the plaintiff's purchase price was subsequently removed from the stock's price, thereby causing losses to the plaintiff.'"[52] The court provided a simple illustration of loss causation in the context of an electronics manufacturer that produces both laptop computers and televisions.[53] A material misrepresentation in the laptop segment that caused a 50% increase in the company's stock price (from $20 to $30 per share) would not give rise to a § 10(b) claim if the company reports that its television business is poorly performing and thus the stock price declined by 50% (from $30 to $15 per share).[54] In essence, the misrepresentation in the laptop segment did not cause the plaintiff's loss; rather, traditional business forces did, and the artificial inflation resulting from the laptop misrepresentation still is reflected in the $15 stock price.[55] Yet, if the laptop misrepresentation subsequently is discovered and disclosed through a corrective disclosure, declines in stock price attributable to that corrective disclosure will be actionable.[56] The court was quick to point out that the loss-causation element does not require proof that the material misstatement is the sole cause of the loss, but that it must be a "substantial or significant cause" of the stock-price decline.[57]

The court set out the elements necessary to show loss causation in a fraud-on-the-market reliance case:

> (1) identifying a "corrective disclosure" (a release of information that reveals to the market the pertinent truth that was previously concealed or obscured by the company's fraud); (2) showing that the stock price dropped soon after the corrective disclosure; and (3) eliminating other possible explanations for this price drop, so that the factfinder can infer that it is more probable than not that it was the corrective disclosure—as opposed to other possible depressive factors—that caused at least a "substantial" amount of the price drop.[58]

52. *Id.* (quoting Hubbard v. BankAtlantic Bancorp, Inc., 688 F.3d 713, 725 (11th Cir. 2012)).
53. *Id.*
54. *Id.* at 1195-96.
55. *Id.* at 1196.
56. *Id.*
57. *Id.* (quoting *Hubbard*, 688 F.3d at 725) (internal quotation marks omitted).
58. *Id.* at 1196-97 (quoting FindWhat Investor Grp. v. FindWhat.com, 658 F.3d 1282, 1311-12 (11th Cir. 2011).

The court stated that the first element—'a corrective disclosure' —"must . . . relate back to the misrepresentation,"[59] and that a corrective disclosure can take the form of "a series of partial disclosures."[60]

The court then applied the plaintiffs' asserted corrective disclosures, specifically the Einhorn presentation, the SEC investigation announcement, and the heightened SEC investigation announcement, to these elements.[61] The court was unmoved by the plaintiffs' argument that the Einhorn presentation constituted a corrective disclosure.[62] The court pointed out that the bedrock of the fraud-on-the-market theory is the efficient market hypothesis—that a market that is operating efficiently has incorporated all publicly available information into the stock price.[63] "A corollary of the efficient market hypothesis is that disclosure of . . . information already known . . . will not cause a change in the stock price"[64] and that "[c]orrective disclosures must present facts to the market that are new, that is, publicly revealed for the first time."[65] The court pointed to the fact that Einhorn's presentation, by its own disclaimer, was gathered from public filings and other publicly available information—thus, there was no new information being provided that could constitute a corrective disclosure.[66] The court held that the plaintiffs' assertion that the fraud-on-the-market theory was appropriate for reliance, yet publicly available information could suffice for causation, was contradictory and chose not to attempt to reconcile the two.[67] Instead, the court pointed out the "Delphic sword" perils of pleading the fraud-on-the-market theory; the court explained that because an efficient market has taken into account all publicly available information, and that information is reflected in the stock price, a plaintiff cannot set aside this premise and assert the re-disclosure of already public information caused the stock price to decline.[68] The court went further by stating the following:

59. *Id.* at 1197 (quoting *In re* Williams Secs. Litig.–WCG Subclass, 558 F.3d 1130, 1140 (10th Cir. 2009)).

60. *Id.* (quoting Lormand v. US Unwired, Inc., 565 F.3d 228, 261 (5th Cir. 2009).

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.* (quoting *FindWhat Investor Grp.*, 658 F.3d at 1310).

65. *Id.* at 1197-98 (alteration in the original) (quoting Katyle v. Penn Nat'l Gaming, Inc., 637 F.3d 462, 473 (4th Cir. 2011)).

66. *Id.* at 1198.

67. *Id.*

68. *Id.* at 1198-99.

> [p]ut another way, because the information used in the presentation had already been public for some time, the decline in the value of St. Joe's shares in the wake of the Einhorn Presentation was not due to the fact that the presentation was revelatory of any fraud, but was instead due to "changed investor expectations" after an investor who wielded great clout in the industry voiced a negative opinion about the Company.[69]
>
> If every analyst or short-seller's opinion based on already-public information could form the basis for a corrective disclosure, then every investor who suffers a loss in the financial markets could sue under § 10(b) using an analyst's negative analysis of public filings as a corrective disclosure. That cannot be—nor is it—the law.[70]

Next, the court turned to the plaintiffs' assertion that announcement of the SEC investigation and later heightened investigation constituted corrective disclosures and thus loss causation.[71] The plaintiffs argued that the investigations covered the same subject matter, namely the value of St. Joe's real estate holdings and that there was a drop in St. Joe's stock price shortly after announcing the investigations.[72] However, the court pointed to the requirement that "a corrective disclosure must 'reveal[] to the market the falsity of [a] prior misstatement[].'"[73] The court did not find any such revelation, but, to the contrary, pointed to a statement in the company's initial disclosure of the SEC investigation stating that the "notification from the SEC does not indicate any allegations of wrongdoing, and an inquiry is not an indication of any violations of federal securities laws."[74] The court pointed to a number of district court cases holding that disclosure of an investigation is not a corrective disclosure, but as a case of first impression at the circuit court level, the court created precedent in ruling "the commencement of an SEC investigation, without more, is insufficient to constitute a corrective disclosure for purposes of § 10(b)."[75] In supporting this conclusion, the court stated,

> To be sure, stock prices may fall upon the announcement of an SEC investigation, but that is because the investigation can be seen to

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69. *Id.* at 1200 (quoting *Duna Pharms., Inc.*, 544 U.S. at 343).
70. *Id.* at 1199.
71. *Id.* at 1200.
72. *Id.*
73. *Id.* (alterations in the original) (quoting *FindWhat Investor Grp.*, 658 F.3d at 1311 n.28).
74. *Id.* at 1201 (quoting the trial court record).
75. *Id.*

> portend an added *risk* of future corrective action. That does not mean that the investigations, in and of themselves, reveal to the market that a company's previous statements were false or fraudulent.[76]

In affirming the district court's dismissal of the complaint for lack of loss causation, the court summarized its holding by stating as follows:

> In the financial markets, not every bit of bad news that has a negative effect on the price of a security necessarily has a *corrective* effect for purposes of loss causation. And though we appreciate the importance of private securities fraud actions in deterring fraud and promoting confidence in the marketplace, we are equally mindful that their purpose is "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." Our decision today ensures that loss causation remains a key sentinel in striking that delicate balance.[77]

III. THE ELEVENTH CIRCUIT ADDRESSES MATERIALITY IN SEC ENFORCEMENT ACTIONS

In 2012, the Eleventh Circuit addressed two SEC enforcement cases that focused on the materiality standard in § 10(b) and Rule 10b-5 securities fraud. Interestingly, the court ruled for the SEC in a case where a large investment bank allegedly was involved in fraud stemming from a wide market issue, namely, auction rate securities transactions, and ruled against the SEC in a case where fraud was not only alleged, but admitted, by an individual of a smaller brokerage firm.

In *SEC v. Morgan Keegan & Co.*,[78] the court considered the effect an oral misrepresentation by an individual broker to a small class of investors has on the materiality element of a § 10(b) claim where there existed detailed written disclosures correcting this misstatement.[79] The claims arose from the meltdown and resulting illiquidity of the Auction Rate Securities (ARS) market in the United States during late 2007 and the spring of 2008. During this period, Morgan Keegan prepared and made available numerous written documents describing the ARS auction process and liquidity risks. Yet, it was alleged that on certain occasions during the period of growing illiquidity and uncertainty in the ARS market, Morgan Keegan brokers continued to tout orally ARS invest-

76. *Id.*
77. *Id.* at 1202 (quoting *Dura Pharms., Inc.*, 544 U.S. at 345).
78. 678 F.3d 1233 (11th Cir. 2012).
79. *Id.* at 1233.

ments in a manner contrary to the written disclosures.[80] The SEC brought suit against Morgan Keegan alleging violation of §§ 10(b) and 15(c)(1)[81] and Rule 10b-5 of the Exchange Act, and § 17(a)[82] of the Securities Act.[83] The United States District Court for the Northern District of Georgia held that the required materiality element was not satisfied because the misrepresentations to a few investors did not "significantly alter[] the 'total mix' of information available" to a reasonable investor.[84]

The Eleventh Circuit first considered the elements of a § 10(b) claim, specifically, "(1) a material misrepresentation or materially misleading omission, (2) in connection with the purchase or sale of a security, (3) made with scienter."[85] The court noted that, unlike private causes of action, the SEC does not have to prove reliance and causation.[86] Based upon Morgan Keegan's grounds for dismissal at the district court—solely lack of materiality—the court determined that all other elements of the § 10(b) claim existed.[87] The court then applied the long-standing Supreme Court materiality test, namely that

> [a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [take a particular action relative to the security] . . . [i]n other words, . . . if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[88]

The court then applied this test to the facts of that case. Morgan Keegan asserted that the misstatements were not material because they

80. *Id.* at 1237-42. The SEC provided witness testimony from customers stating that they were told by Morgan Keegan brokers that ARS

> (1) were "as good as cash"; (2) were "as good as money"; (3) were "just like money markets and CDs"; (4) were "cash equivalents to CDs and money markets"; (5) were "just as good as" an investment in a CD insured by the FDIC; (6) were "completely liquid" except for a "possible 35-day hold"; (7) presented "zero concerns [and] zero risk"; and (8) involved "absolutely no risk."

Id. at 1242 (alteration in original).

81. 15 U.S.C. 78o (2012).

82. 15 U.S.C. 78q (2012).

83. *Morgan Keegan & Co.*, 678 F.3d at 1236.

84. *Id.* at 1243-44.

85. *Id.* at 1244.

86. *Id.*

87. *Id.*

88. *Id.* at 1245 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

were made only to a few investors and not to the public as a whole.[89] In dismissing this argument, the court stated that the materiality element requires a review of the misstatement from a reasonable investor's (singular) perspective, not that of the public.[90] "[T]he materiality test requires the court to consider *all* the information available to the hypothetical reasonable investor, which necessarily includes private communications . . . [a]nd the fact-finder could easily conclude that a reasonable investor would find liquidity risk an important factor in determining whether to invest in ARS. . . ."[91] The court further stated that the SEC is only required to prove materiality and scienter in a misrepresentation and the insignificance of the effect on the public is irrelevant to an enforcement action: "The extent of the brokers' misrepresentations may ultimately affect the size of the remedy, such as fines or disgorgement," but not materiality.[92]

The court then considered the effect of Morgan Keegan's written disclosures on the oral misstatements. Morgan Keegan asserted that the written disclosures contradicted and corrected the brokers' oral statements and thus rendered the oral misstatements immaterial.[93] The court stated that the manner in which information is disseminated (orally or written) is relevant to materiality; however, there is no rule that precludes an investor "from recovering under Rule 10b-5 if the misrepresentations upon which the investor relied were oral and conflict in some way with contemporaneous written representations available to the investor."[94] Analogizing from private action cases that have ruled on this issue in the context of analyzing reliance, the court stated that whether written disclosures render oral misstatements immaterial is an intense facts-and-circumstances review.[95] The court then considered how the written disclosure materials were disseminated to customers. The court noted that Morgan Keegan lacked evidence that it delivered the written disclosures, citing testimony from clients stating they had not received written disclosures prior to purchasing ARS, no evidence that brokers directed customers to the Morgan Keegan website containing ARS disclosures, and an improper reliance on a written trade confirmation that was delivered to customers only after the ARS trade

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89. *Id.* at 1247.
90. *Id.* at 1248.
91. *Id.* at 1248, 1249.
92. *Id.* at 1249.
93. *Id.* at 1250.
94. *Id.* (quoting Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989)).
95. *Id.* at 1250-51 (*comparing Bruschi*, 876 F.2d 1526, *with* First Union Discount Brokerage Servs., Inc. v. Milos, 997 F.2d 835 (11th Cir. 1993)).

had occurred.[96] The court held that the written disclosures, while adequate in substance, were "distributed only in [a] weak or non-effective manner" and thus did not render the direct oral misstatements to be immaterial.[97]

Finally, Morgan Keegan asserted that the availability of the written disclosures to any "reasonably diligent investor" caused the oral misrepresentations to be immaterial.[98] The court summarily dismissed this argument, noting that an investor-diligence requirement is a reliance concept, and reliance is not an element of Rule 10b-5 SEC-enforcement claims.[99]

The Eleventh Circuit once again addressed the issue of materiality in an SEC enforcement action in *SEC v. Goble*.[100] In *Goble*, the defendant was the founder of a securities-and-clearing brokerage firm. The enforcement action stemmed from the defendant's admitted fraud in overstating the brokerage firm's reserve account maintained in accordance with the Consumer Protection Rule.[101] In summary, the Consumer Protection Rule requires an amount equal to a certain percentage of client funds held by a brokerage firm to be deposited in a special account. If the account balance falls below this certain percentage, the brokerage firm is required to deposit more money. Likewise, if the account has excess money relative to the percentage threshold, the brokerage firm may remove the excess.[102] Faced with financial difficulties, the defendant overstated the reserve account balance by entering a false money market purchase on the account's ledgers, thus falsely reflecting a considerably higher value.[103] That inflated value permitted the defendant to withdraw a significant amount of money from the account, rendering the account severely underfunded.[104]

The SEC brought a § 10(b) and Rule 10b-5 claim against the defendant.[105] The United States District Court for the Middle District of Florida found that the defendant had violated § 10(b) and Rule 10b-5.[106] In reviewing the case, the Eleventh Circuit applied the test for § 10(b) liability: "(1) material misrepresentations or materially mislead-

96. *Id.* at 1252, 1253.
97. *Id.* at 1253.
98. *Id.* (quoting the trial court record).
99. *Id.*
100. 682 F.3d 934 (11th Cir. 2012).
101. *Id.* at 940, 941; 17 C.F.R. § 240.15c33 (2013).
102. *Goble*, 682 F.3d at 940-41.
103. *Id.* at 941.
104. *Id.*
105. *Id.* at 942.
106. *Id.*

ing omissions, (2) in connection with the purchase or sale of securities, (3) made with scienter."[107] The defendant asserted that his misstatement was not material because it was only in an internal record and not made to customers or the public as required by § 10(b). The SEC argued that the internal record misstatement was material because it hid the insecurity of the brokerage firm, and this insecurity would be material to customers in choosing a broker-dealer to process their transactions.[108] The court again looked to the test for materiality: "whether a reasonable man would attach importance to the fact misrepresented or omitted in determining his course of action."[109] The court determined that "course of action" "mean[s] an investment decision—not an individual's choice of broker-dealers."[110] The court held that misstatements that only affect broker-dealer selection cannot be the basis for a § 10(b) claim because it is not tied to an investment decision.[111]

Despite disposing of the § 10(b) claim based upon immateriality, the court also considered the defendant's additional assertion that the misstatement was not in connection with the purchase or sale of securities. The SEC contended that the sham money-market purchase constituted a securities transaction.[112] The court looked to the intentions behind the "in connection with" requirement to determine if the sham transaction fell within the element.[113] The court held that § 10(b) does not require an actual purchase or sale of securities.[114] However, the court distinguished *Goble* from prior cases by pointing to the fact that Goble did not take money for a securities transaction, no securities ownership changed hands, and there was no promise to purchase a security.[115] To the contrary, the court held that the inaccurate book entry was just that, a book entry, and not a securities transaction actionable under § 10(b).[116]

107. *Id.* at 942-43 (quoting SEC v. Merch. Capital, LLC, 483 F.3d 747, 766 (11th Cir. 2007)).
108. *Id.* at 943.
109. *Id.* (quoting *Merch. Capital, LLC*, 483 F.3d at 766).
110. *Id.*
111. *Id.* at 944.
112. *Id.* at 944-45.
113. *Id.* at 945.
114. *Id.* at 946.
115. *Id.*
116. *Id.*

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