Simpson Thacher

Securities Law Alert

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Simpson Thacher's "deep bench of trial and appellate lawyers" is "regularly retained to act on multibillion-dollar securities class actions and derivative suits."

–Chambers USA

Second Circuit: "Tentative and Generic" Compliance-Related Statements Are Not Actionable Securities Fraud

On March 5, 2019, the Second Circuit affirmed dismissal of a securities fraud action alleging that a health services company made misstatements concerning its regulatory compliance. *Singh v. Cigna Corp.*, 2019 WL 1029597 (2d Cir. 2019) (Cabranes, J.). The court cautioned that plaintiffs cannot assert "a prima facie case of securities fraud" merely by "point[ing] to banal and vague corporate statements affirming the importance of regulatory compliance" coupled with "significant regulatory violations." The court emphasized that "such generic statements do not invite reasonable reliance."

The Second Circuit found that compliance-related statements in the company's Code of Ethics were "textbook example[s] of puffery" because they were simply "general declarations about the importance of acting lawfully and with integrity." The court explained that broad and non-specific "statements about reputation, integrity, and compliance with ethical norms . . . are too general to cause a reasonable investor to rely upon them."

The Second Circuit further held that a reasonable investor would not rely upon the "tentative and generic" compliance-related statements in the company's SEC filings, particularly because those statements were "framed by acknowledgements of the complexity and numerosity of applicable regulations." The court observed that "[s]uch framing suggests caution (rather than confidence) regarding the extent of [the company's] compliance." The court also noted that in cases where it has found compliance-related statements to be "actionable assurances of actual compliance, the descriptions of such [compliance-related] efforts were far more detailed" than those at issue in the case before it.

Eighth Circuit: Omitting Projected Net Income/Loss Information May Render a Proxy Statement Materially Misleading in Violation of Section 14(a) and Rule 14a-9

On March 1, 2019, the Eighth Circuit reversed the dismissal of a securities fraud action alleging that a company's proxy statement in connection with a proposed merger was materially misleading in violation of Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9 where the proxy statement failed to disclose projected net income/loss information for the pre-merger target company. *Campbell v. Transgenomic*, 2019 WL 983676 (8th Cir. 2019) (Benton, J.). The Eighth Circuit reasoned that "projected net income/loss is not trivial information" and "may be of more significance to investors than revenue."

The district court had noted that Section 14(a) and SEC Rule 14a-9 are not "so broad as to require the proxy statement to include *every* possible financial disclosure that *may* be relevant to the valuation of a business." *Campbell v. Transgenomic*, 2018 WL 2063348 (D. Neb. May 3, 2018). The district court determined that "the crux of the analysis is this: where the proxy statement chooses to disclose a financial valuation, does it do so honestly?" The district court found that the net income/loss data did not "call into question the accuracy of the information disclosed" in the proxy statement, such as revenue distributions, and dismissed plaintiffs' claims.

On appeal, the Eighth Circuit found the district court had applied "the wrong inquiry." The Eighth Circuit explained that "Section 14(a) was intended to promote the free exercise of the voting rights of stockholders by ensuring that proxies would be solicited with explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." The Eighth Circuit stated that, for purposes of SEC Rule 14a-9, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." The court further noted that "[u]nder this test it is not necessary to prove that disclosure of an omitted fact would have caused a reasonable investor to change his decision."

The Eighth Circuit observed that it has "considered net income to be among the three most valuable figures in determining the fairness of an acquisition under the Clayton Act." The Eighth Circuit found that the pre-merger company's net income/loss figures were particularly relevant in the case before it because the proxy statement included gross profit projections for the pre-merger company. The Eighth Circuit found that "[b]y omitting the (allegedly) significantly lower projections for [the company's] net income/loss, the proxy statement may have presented [the company] in a false light that was materially misleading." The Eighth Circuit concluded that "a reasonable investor may have viewed disclosure of [the company's] net income/loss as having significantly altered the total mix of information made available," and therefore "the materiality of the omission was improperly resolved as a matter of law." In so holding, the Eighth Circuit underscored that "[d]oubts as to the critical nature of information misstated or omitted" should be "resolved in favor of those [SEC Rule 14a-9] is designed to protect."

Southern District of New York: Duty to Disclose Under Item 303 of Regulation S-K Is Limited to "Known Risks" With a "Fairly Substantial Probability" of Having a "Material Impact"

On February 26, 2019, the Southern District of New York dismissed in its entirety a securities fraud action against an online hotel search platform operator and the underwriters of its IPO. *Holbrook v. Trivago*, 2019 WL 948809 (S.D.N.Y. 2019) (Buchwald, J.).[1] The court found defendants had no obligation under Section 11 of the Securities Act of 1933 to disclose in the company's IPO Registration Statement either (i) violations of the company's landing page standards by the company's largest advertiser, or (ii) a modification to the company's market algorithm known as the "relevance

1. Simpson Thacher represents the underwriters of Trivago's initial public offering in this matter.

assessment" that imposed financial penalties on advertisers that failed to adhere to the company's landing page standards. The relevance assessment temporarily boosted revenues in the months following the IPO, but revenues dropped once advertisers began conforming their landing pages to the company's standards.

Plaintiffs contended that defendants had a duty to disclose these issues under Item 303 of Regulation S-K, which requires the disclosure of "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." 17 C.F.R. § 229.303(a)(3)(ii). The court explained that Item 303's "'reasonably expects will have' standard suggests that there must be a fairly substantial probability that the known risk at issue will materialize and have a material impact—if not a more-likely-than-not standard, then something not too much below that."

The court found plaintiffs failed to plead "any factual allegation from which to infer that" the violations of the company's landing page standards by its largest advertiser were "of the scope and magnitude necessary to impute knowledge of likely materiality." The court further found that the company's implementation of the relevance assessment to incentivize the advertiser's compliance was "of no moment." The court reasoned that "[t]he mere fact of a change in policy does not render the impetus for that change material for purposes of Item 303."

The court deemed equally meritless plaintiffs' contention that the company "should have known that the relevance assessment would have a significant impact on future revenues because it had observed increased revenue attributable to the relevance assessment for (at most) 15 days" prior to the IPO. The court reasoned that "[t]he payment of penalties of unspecified scale and significance over such a brief period of time simply does not support conclusions about how or when advertisers would react to the relevance assessment going forward from the time of" the IPO. The court stated that "as a matter of law 15 days does not a trend make."

The court also rejected plaintiffs' argument that these omissions rendered other aspects of the IPO Registration Statement materially misleading. The court explained that "[t]he touchstone for a finding that otherwise true statements have been rendered misleading by omissions is whether such information was necessary in light of the context, manner of presentation, and language of the statements at issue so that what was revealed would not be so incomplete as to mislead." The court noted that "a duty to disclose does not spring solely from plaintiffs' interest in that omitted fact." Here, the court found there was no duty to disclose triggered by, for example, the company's "broad, non-specific description of pricing" or its enumeration of a generalized and "non-exclusive list of factors that could cause [the company] to downwardly deviate from its historical growth rates."

The court dismissed plaintiffs' claims under Sections 11 and 15 of the Securities Act, as well as plaintiffs' related claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The court denied plaintiffs leave to amend.

District of Minnesota: Summary Judgment Granted to Defendants in a Securities Fraud Action Based on Plaintiffs' Failure to Prove Reliance

On March 8, 2019, the District of Minnesota granted defendants' motion for summary judgment in a long-pending securities fraud action against a major electronics retailer. *IBEW Local 98 Pension Fund v. Best Buy Co.*, 2019 WL 1102714 (D. Minn. 2019) (Frank, J.).[2] The court dismissed

2. Simpson Thacher represents Best Buy and several of its executives in this action.

plaintiffs' claims in full and with prejudice because plaintiffs failed to meet their burden of proving reliance upon alleged misrepresentations made during a September 14, 2010 conference call.

Plaintiffs sought to invoke the fraud-on-the-market presumption of reliance established in *Basic v. Levinson*, 485 U.S. 224 (1988). The district court initially granted class certification, but the Eighth Circuit reversed because it found that defendants "rebutted the *Basic* presumption by submitting direct evidence . . . that severed any link between the alleged conference call misrepresentations and the stock price at which plaintiffs purchased." *IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016).[3] Following the Eighth Circuit's ruling, the district court found that plaintiffs could only "proceed with traditional evidence of reliance." *IBEW Local 98 Pension Fund v. Best Buy*, 2017 WL 2728399 (D. Minn. June 23, 2017).

Defendants later moved for summary judgment on the ground that plaintiffs could not satisfy their burden of proving actual reliance. Defendants cited the lead plaintiff's testimony that he had not heard or read about the conference call statements prior to purchasing the company's shares. Defendants also pointed out that there was no evidence in the record that either of the other two plaintiffs had relied on the conference call statements in purchasing their shares. Because the court found that there was no genuine dispute of material fact concerning actual reliance, the court determined that there was "no triable claim for securities fraud."

3. Please click here to read our prior discussion of the Eighth Circuit's decision in *Best Buy*.

Southern District of California: Digital Tokens Sold in Initial Coin Offerings Are Securities

On February 14, 2019, the Southern District of California held that digital tokens sold in an initial coin offering ("ICO") constitute securities under the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *SEC v. Blockvest*, 2019 WL 625163 (S.D. Cal. 2019) (Curiel, J.) (*Blockvest II*).

An ICO is a "fundraising event" in which an entity offers investors unique digital tokens or assets in exchange for virtual currency or other consideration. Each digital token "may entitle its holders to certain rights related to a venture underlying the ICO, such as rights to profits," and "may also be listed on online trading platforms." Issuers typically promote ICOs through social media and other online methods, and also "usually release a 'Whitepaper' describing the project and the terms of the ICO."

In *Blockvest*, the SEC brought suit against a company that offered digital tokens through an allegedly fraudulent ICO, as well as the company's chairman, under Section 10(b) of the Securities Exchange Act of 1934 and Sections 17(a)(1), (2) and (3) of the Securities Act of 1933, among other claims. The SEC moved for a preliminary injunction to halt the ICO and freeze the assets of the company and its chairman. The Southern District of California initially found that it could not determine whether the digital tokens at issue constituted securities and denied the SEC's motion for a preliminary injunction, but granted the SEC's request to freeze assets and protect investors from the potential dissipation of the company's and CEO's assets. *SEC v. Blockvest*, 2018 WL 6181408 (S.D. Cal. Nov. 27, 2018) (Curiel, J.).

On reconsideration, the court held that the digital tokens offered in the ICO at issue satisfied "*Howey*'s three-part test" for determining whether an investment opportunity is a "security." *Howey* "requires (1) an investment of money (2) in a common enterprise (3) with an expectation of profits produced by the efforts of others." The *Blockvest II* court explained that "[a]n investment of money can take the form of goods and services . . . or exchange of value."

The court found that "[d]efendants' website and their Whitepaper's invitation to potential investors to provide digital currency in return for [digital] tokens satisfies" the first prong of the *Howey* test. The court held that *Howey*'s second prong was met because defendants "claimed that the funds raised [through the ICO] will be pooled and there would be a profit sharing formula." Finally, the court determined that *Howey*'s third prong was satisfied because, "as described on the website and Whitepaper, the investors in [the ICO] would be 'passive' investors and the [digital] tokens would generate 'passive income.'" The court concluded that "the promotion of the ICO of the [company's] token was a 'security'" under the *Howey* test.

The *Blockvest II* court granted the SEC's motion for a preliminary injunction with respect to the ICO even though defendants contended that the digital tokens were designed merely for the purposes of testing the company's platform, and no actual sales of the tokens had taken place. The court found defendants could nevertheless face securities fraud liability because defendants' promotion of the ICO constituted an "offer" of unregistered "securities" for purposes of Section 17(a). The court stated that "Section 17(a) is intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." The court explained that "[u]nder securities law and caselaw, the definition of 'offer' is broad and there is no requirement that performance must be possible or that the issuer must be able to legally bind a purchaser."

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