

Second Circuit Reverses Dismissal of Securities Claim Alleging Failure to Disclose SEC Investigation

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The Court of Appeals for the Second Circuit yesterday reversed the dismissal of a securities class action alleging fraud based on the defendants' failure to disclose an SEC investigation into the company's disclosed financial-control weaknesses. The May 24, 2022 ruling in *Noto v. 22nd Century Group, Inc.* (No. 21-0347) is fact-specific, requiring disclosure of the investigation because the defendants (i) had disclosed the accounting deficiencies that had led to the investigation, (ii) had said they were working on the problem, and (iii) eventually had said they had resolved it, even though the SEC investigation had been pending during that entire period.

The *Noto* decision could affect disclosure assessments where issuers disclose an underlying accounting problem or other deficiency but are debating whether they must also disclose a pending SEC or other governmental investigation related to that specific problem. Depending on the facts and circumstances of the particular situation, a court might hold that failure to disclose the governmental investigation makes the disclosure of the underlying problem materially misleading because nondisclosure of the investigation could cause reasonable investors to make "an overly optimistic assessment of the risk" posed by the underlying problem.

Factual Background

The corporate defendant in the *Noto* case disclosed in its 2015 Form 10-K report that its "internal controls over financial reporting were not effective and that material weaknesses exist[ed] in [its] internal control over financial reporting' as it related to segregation of duties." The company made similar disclosures in its first three quarterly reports for 2016 and said it was undertaking remediation efforts. The company later announced in 2018 that it had "completed the implementation and testing of a remediation plan'" to address the accounting weaknesses.

Plaintiffs alleged that these statements were materially false or misleading because, starting at least in 2016 and continuing into 2018 or 2019, the SEC had been investigating the company's accounting weaknesses. Moreover, in August 2018, the SEC had denied a nonpublic FOIA request pursuant to an exemption authorizing withholding of records that might interfere with an enforcement proceeding.

In October 2018, an online commentator disclosed the denial of the FOIA request and suggested that the SEC was investigating the company. The stock price fell, and litigation ensued.

The District Court dismissed the case, holding that the company had no duty to disclose the investigation, but the Second Circuit vacated that portion of the District Court's ruling.

The Second Circuit's Decision

The Second Circuit focused on the factual allegations and held that the defendants "had a duty to disclose the SEC investigation in light of the specific statements they made about the Company's accounting weaknesses." "[B]y not mentioning the investigation, [defendants'] disclosures of the accounting deficiencies were misleading."

The court reasoned that "the fact of the SEC investigation would directly bear on the reasonable investor's assessment of the severity of the reported accounting weaknesses. . . . Because defendants here specifically noted the deficiencies and that they were working on the problem, and then stated that they had solved the issue, the failure to disclose [the investigation] would cause a reasonable investor to make an overly optimistic assessment of the risk." Defendants therefore had a duty to disclose the SEC investigation into the accounting weaknesses.

The court also ruled that the nondisclosure of the SEC investigation "remained a material omission even after the Company represented that it had rectified the problem because the SEC investigation was ongoing. By not disclosing that the SEC was investigating the Company's specific accounting weaknesses, defendants' statements about that weakness were not accurate and complete."

Implications

Issuers frequently wrestle with whether they must disclose a pending SEC or other governmental investigation that has not yet resulted (and might never result) in an enforcement proceeding, much less a finding of wrongdoing. Disclosure considerations sometimes focus on the stage of the investigation – for example, whether the SEC has issued a “Wells notice” indicating the staff’s interest in commencing an enforcement proceeding, or whether the investigation is in a more preliminary phase.

The *Noto* decision does not focus on the stage of the investigation; it considers what the company has disclosed about the underlying problem and whether the nondisclosure of the governmental investigation into that specific problem would mislead a reasonable investor into minimizing the related risks. This analysis could affect issuers’ assessments about the need to disclose investigations into underlying disclosed problems.

But the decision here is closely tied to the plaintiffs’ factual allegations. For example, what if the issuer had not said that it had *resolved* the underlying accounting issues, but had disclosed only the accounting deficiencies themselves and, perhaps, its undertaking steps to remediate them? In that scenario, without a statement that the problems had been resolved, would the failure to disclose the ongoing SEC investigation still have caused a reasonable investor to make “an overly optimistic assessment of the risk”? The *Noto* decision does not answer that question.

Subsequent cases might also explore whether *Noto*’s holding turned on the fact that the underlying disclosed issue was an accounting weakness, rather than a one-time event. A failure in internal controls over financial reporting could have a variety of ramifications, which might not all have been separately disclosed or even ascertainable. In that situation, it is possible that, without knowing of a pending SEC investigation, investors might be more likely to be “overly optimistic” about the underlying risk than where the disclosed risk is a one-time occurrence that has already materialized.

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