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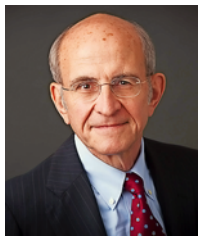
DISCLOSURE

When Rules Collide --*Leidos*, the Supreme Court, and the Risk to the MD&A


BY LINDA L. GRIGGS, JOHN J. HUBER, AND CHRISTIAN J. MIXTER

The Supreme Court is poised to decide whether sub-item (a)(3)(ii) of Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations, 17 C.F.R. § 229.303 (''MD&A'' or ''Item 303''),creates a duty to disclose that is actionable by private plaintiffs under Rule 10b-5, 17 CFR § 240.10b-5, adopted pursuant to Section 10(b) of the Securities Exchange Act of 1934 (the ''Exchange Act''), 15 USC § 78j(b). If the Court concludes that Item 303 creates such a duty, the Court will likely also address other conditions to Rule 10b-5 liability, such as materiality and scienter. The vehicle for that decision will be the Supreme Court's review of *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016). (Because of a corporate name change, we refer to both the defendant company and the Second Circuit's decision as ''*Leidos*.'') In *Leidos*, the Second Circuit broke with the Third and Ninth Circuits and held that a public company that omits a disclosure required by Item 303 violates a duty to disclose under Rule 10b-5. In resolving this conflict between the circuits with respect to Item 303(a)(3)(ii), the Court's decision will also likely affect whether Rule 10b-5 would apply to a violation of every other sub-item of Item 303 as well as every one of the disclosure requirements adopted by the Securities and Exchange Commission (the ''SEC'' or the ''Commission'') under Sections 13(a) and 15(d) and perhaps Section 14(a) of the Exchange Act, which would usher in a new era of litigation under Rule 10b-5.

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This Article considers the issues before the Supreme Court from three perspectives. In Part I, we discuss the history and purpose of Item 303, as well as the SEC's enforcement of the disclosure requirements contained in that Item. In Parts II and III, we summarize the circuit split, make some observations about the legal implications of the Second Circuit's decision, and discuss the likely negative effects that would flow from a Supreme Court affirmance of that decision.

Part I: The Origins and Purpose of MD&A

Item 303 is part of Regulation S-K, which is the central repository of disclosure for periodic reports under the Exchange Act and registration statements under the

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Securities Act of 1933 (the ''Securities Act''). Adopted in 1980, Item 303 represented an effort by the SEC to respond to criticisms by investors about the prior disclosure requirements that were contained in the agency's Guide No. 1 (Summary of Operations) and Guide No. 22 (Summary of Earnings). The two Guides were part of the Guides for Preparation and Filing of Registration Statements under the Securities Act. Guidelines for Registration and Reporting, Securities Act Rel. No. 5520 (August 14, 1974) [39 FR 31894] (the ''1974 Release''). (In this article, SEC releases that are available as of September 1, 2017 on the SEC's Website, www.sec.gov, are cited only to their release numbers and dates; older releases are cited to other sources such as the Federal Register.)

Originally adopted in 1968 and reflecting the policies and practices of the SEC's Division of Corporation Finance (the ''Division''), Guide 22 applied to registration statements and focused on a summary of earnings. Guides for Preparation and Filing of Registration Statements, Securities Act Rel. No. 4936 (December 9, 1968) [33 FR 18617]. Guide 1 applied to Exchange Act filings and dealt with a company's operations. 1974 Release. When it adopted Guide 1 in 1974, the SEC changed the titles of both Guides; Guide 22 became ''Management's Discussion and Analysis of the Summary of Earnings'' and Guide 1 became ''Management's Discussion and Analysis of the Summary of Operations.'' Id., 39 FR at 31895. See also Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Rel. No. 33-6711 (April 24, 1987) [52 FR 13715] (the ''1987 Release'').

As the SEC has put it, ''Prior to 1980, Commission rules required registrants to provide a summary of earnings, including a discussion of unusual conditions that affected the appropriateness of the earnings presentations. The rules also required registrants to discuss items of revenue or expense that changed more than ten percent from the prior period or changed more than two percent of the average net income or loss for the most recent three years presented.'' Business and Financial Disclosure Required by Regulation S-K, Securities Act Rel. No. 10064 (April 13, 2016) (the ''Concept Release'') at 100-101. ''However, disclosure also was required if an item did not meet the applicable percentage test but was necessary to an understanding of the summary. Conversely, where a registrant believed that a particular item was unnecessary to an understanding of the summary, the Division considered petitions for exemptions where the percentage test was met.'' 1987 Release, 52 FR at 13716.

Investors believed that the disclosure that public companies were providing pursuant to Guides 1 and 22 was mechanistic and did not provide meaningful disclosure. Public companies informed the SEC that a flexible disclosure item would permit management to exercise judgment in making disclosure that would result in providing meaningful information to investors and the marketplace. A flexible requirement permitting the exercise of judgment would enable managements to tell their story, instead of providing disclosure that essentially said: ''Operating income increased 10% because revenue increased 10%.''

In contrast to prescriptive requirements like Guides 1 and 22, Item 303 provides flexibility. An example is the SEC's description of the terms ''liquidity'' and capital resources,'' as used in Item 303. While the terms ''lack some precision in definition, it is believed that additional specificity would decrease the flexibility needed by management for a meaningful discussion.'' Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Act Disclosure Systems, Securities Act Rel. No. 6231 (Sept. 2, 1980) [45 FR 63630] (the ''1980 Release'') at 63636. Thus, Item 303 can be viewed as one of the SEC's initial efforts at adopting a principles-based disclosure requirement, which the agency has described as follows: ''These rules rely on a registrant's management to evaluate the significance of information in the context of the registrant's overall business and financial circumstances and determine whether disclosure is necessary. The requirements are often referred to as 'principles-based' because they articulate a disclosure objective and look to management to exercise judgment in satisfying that objective.'' Concept Release at 34-35 [footnotes omitted].

Item 303's focus is on the financial statements as a whole, not a summary of earnings or operations. In proposing and adopting Item 303, the SEC concluded that ''there is a growing need in today's environment to analyze enterprise liquidity and capital resources,'' as well as inflation and changing prices, topics that were not included in the Guides. 1980 Release, 45 FR at 63636. Within each of liquidity, capital resources and results of operations, Item 303, unlike the Guides, ''required disclosure of favorable or unfavorable trends and identification of certain material events or uncertainties.'' 1987 Release, 52 FR at 13716. Item 303 was broader in scope than Guides 1 and 22, far more comprehensive than the Guides and intentionally general in nature. The Commission believed that a flexible approach would elicit more meaningful disclosure and avoid boilerplate discussions that a more specific approach could foster. ''Further, the Commission reasoned that, because each registrant is unique, no one checklist could be fashioned to cover all registrants comprehensively.'' *Id*. Hence, Item 303 represents a combination of specific requirements and disclosure principles, rather than just a list of specific requirements.

As shown by this administrative history, the SEC made a trade-off in proposing and adopting Item 303. Rather than a prescriptive rule, like Guides 1 and 22, that would have had a high probability of eliciting mechanistic disclosure that was not meaningful to either individual or institutional investors, the SEC adopted a principles-based rule to encourage public companies to tell their story. ''In order to allow registrants to discuss their businesses in the manner most appropriate to individual circumstances and to encourage flexibility, the provisions were intentionally general and offered a minimum of specific requirements.'' Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Rel. No. 6349, 1981 WL 379268 (Sept. 28, 1981) (the ''1981 Release''), at 2. Item 303 does this by: expanding the scope of disclosure beyond operations and earnings to a narrative discussion of the financial statements; requiring an analysis in addition to a discussion; changing from requiring percentage change disclosure to having management disclose known trends or uncertainties; distinguishing between trends that were required to be disclosed and projections, which were not mandated, but encouraged; focusing on items like liquidity and capital resources, which had not received sufficient attention in

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the past; having the narrative disclosure discuss and analyze changes in Generally Accepted Accounting Principles (''GAAP'') and the effects of such changes on the registrant's business; providing segment disclosure or ''other breakdowns such as subdivisions, if investor understanding would thereby be improved,'' 1980 Release, 45 FR at 63637; and allowing management to exercise judgment within the context of specific parameters.

As originally adopted, Item 303(a)(1)-(3) required management to discuss and analyze three core components: liquidity, capital resources and results of operations. In 2003, Item 303 was amended to change the disclosure of inflation and price changes (Item 303(a)(4)), and to require disclosure of off-balance sheet arrangements and contractual obligations (Item 303(a)(5)). Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Rel. No. 8182, (January 28, 2003).

Neither Item 303 itself as promulgated in 1980 nor either of the amendments to Item 303 was adopted pursuant to the SEC's authority under Section 10(b) of the Exchange Act. Instead, Item 303 was adopted in 1980 pursuant to the authority in Sections 5, 7, 8, 10 and 19(a) of the Securities Act and Sections 12, 13, 15(d) and 23(a) of the Exchange Act. 1980 Release, 45 FR at 63847. The 2003 amendments to Item 303 were adopted pursuant to the authority in Sections 7, 10, 19, 27A and 28 of the Securities Act, Sections 12, 13, 14, 21E, 23 and 36 of the Exchange Act, and Sections 3(a) and 401(a) of the Sarbanes-Oxley Act of 2002. Securities Act Rel. No. 8182.

The meaning and application of MD&A has been shaped by periodic reviews of the SEC's disclosure policy, by interpretive releases published by the SEC, through comments issued by the Division in its review of filings, by no-action letters issued by the Division, by SEC enforcement cases and by case law. Even though the meaning and application of Item 303 have been dynamic over the past 37 years, the purposes for which it was adopted have not changed. As the Commission has stated,

> The MD&A requirements are intended to satisfy three principal objectives:
>
> ■ to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
>
> ■ to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
>
> ■ to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Rel. No. 8350 (the ''2003 Release''), at 2.

During the 1980s, public companies attempted to comply with the new Item 303, ''especially the more novel disclosure areas,'' 1981 Release at 2, while the Division reviewed the disclosure made pursuant to a requirement that was ''intentionally general and nonspecific.'' Id. at 1. As discussed below, this did not prevent the SEC from enforcing the requirements of Item 303, but it did present a challenge for the Division's review process. In the early years of Item 303, deferring to management's judgments in complying with a disclosure item titled ''Management's Discussion and Analysis'' often resulted in the Division's review staff asking questions about the disclosure, rather than requiring amendments to the disclosure that was already made. Registrants also found Item 303's approach to be challenging, as evidenced by the examples of MD&A disclosure by public companies contained in a number of the more than a dozen interpretive releases that the SEC has published since 1980.

The concept of encouraging public company managements to ''tell their story'' morphed into giving ''the investor the opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.'' 1987 Release at 13717. The 1989 interpretive release repeated the 1987 Release's description of looking at the company through the eyes of management. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Rel. No. 6835 (May 18, 1989) (the ''1989 Release''), at 3. It also was consistent with past releases in recounting how Item 303 was more comprehensive than earlier formulations and intentionally general, and repeated the SEC's view that a ''flexible approach elicits more meaningful disclosure and avoids boilerplate discussions which a more specific approach could foster.'' *Id*. at 2. A principles-based disclosure item that is general and flexible also enables the SEC to respond more quickly to developments in business and the economy that affect public companies generally without having to propose and adopt amendments to Item 303 pursuant to the Administrative Procedure Act.

One of the six matters on which the 1989 Release provided interpretive guidance was ''prospective information required in MD&A.'' *Id*. Rather than follow prior releases in encouraging, but not requiring forward looking information in MD&A, the 1989 Release included the following statement:

> [S]everal specific provisions in Item 303 require disclosure of forward-looking information. MD&A requires discussions of ''known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.'' Further, descriptions of known material trends in the registrant's capital resources and expected changes in the mix and cost of such resources are required. Disclosure of known trends or uncertainties that the registrant reasonably expects will have a material impact on net sales, revenues, or income from continuing operations is also required. Finally, the instructions to Item 303 state that MD&A ''shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.''

Id. at 4 [footnotes omitted].

Thus, the 1989 Release, like the 1987 Release, distinguished between forward-looking information that was optional or voluntary (*i.e*., disclosure that ''involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty''), 1989 Release at 4, citing 1987 Release at n.1, and required forward-looking disclosure (*i.e*., ''currently known trends, events and uncertainties that are

reasonably expected to have material effects''). *Id*. In an apparent effort to minimize any adverse reaction from registrants that had understood prior releases to say that known trends or uncertainties that were occurring at the time of the filing were not forward-looking, the 1989 Release states that the SEC's safe harbor rules apply to both required and voluntary forward looking disclosure. *See* 1989 Release n. 22, *citing* Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act. (Given the addition of Section 21E to the Exchange Act in 1995, the SEC's description of such disclosure as ''forward-looking'' meant that it would also be covered by that safe harbor. See also Safe Harbor for Forward Looking Statements, Securities Act Rel. No. 7101 (October 13, 1994) at 9.) In addition to clarifying the scope of forward-looking information, this section of the 1989 Release discussed how managements should determine whether forward-looking information concerning a trend, demand, commitment, event or uncertainty is required to be disclosed because it is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation. Management first needs to ''determine and carefully review what trends, demands, commitments, events or uncertainties are known to management.'' 1989 Release at 5. In conducting this review, management needs to consider each specific category of known data under Item 303. In addition to known events that have occurred or are occurring, disclosure is required with respect to planned material events that are reasonably likely to occur. *Id*. ''Events that have already occurred or are anticipated often give rise to known uncertainties.'' *Id*. at 6. After conducting this review, management is ready to make the determination of whether disclosure is required.

Without notice or the opportunity for public comment pursuant to the Administrative Procedure Act, the 1989 Release also introduced a two-step test (the ''Two Step Test'''') for managements to determine whether forward-looking disclosure is required by Item 303:

> Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:
>
> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
>
> (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.

Id. at 6-7.

The 1989 Release added that ''Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time that the determination is made.'' *Id*. at 7.

In presenting the Two Step Test, the 1989 Release stated that Item 303 ''specifies its own standard for disclosure – i.e., reasonably likely to have a material effect. This specific standard governs the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved by the Supreme Court in *Basic, Inc. v. Levinson*, 108 S. Ct. 978 (1988), is inapposite to Item 303 disclosure.'' 1989 Release at n. 27; see also Concept Release at 107. The SEC did not provide a reason for its position, which seems odd given that the probability/magnitude test is particularly appropriate to analyze disclosure of forward-looking information. The Two Step Test has a lower threshold for requiring disclosure of forward-looking information than *Basic*; the SEC has explained that ''reasonably likely,'' which is a less than 50% probability, is a lower threshold than ''more likely than not,'' which is a more than 50% probability.

Indeed, the Two Step Test appears to have set a lower threshold for disclosure than the words of Item 303 itself. For example, Item 303(a)(1) uses the phrase ''reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.'' And Item 303(a)(3)(ii) uses the phrase ''reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.'' One of these sub-items of Item 303 uses ''reasonably likely'' like the Two Step Test and the other uses ''reasonably expects.'' Unlike the Two Step Test, however, the sub-items of Item 303 have materiality as the frame of reference: reasonably expects to be material or reasonable likely to be material, which is a higher standard than how the term ''reasonably likely'' is used in two of the three instances in the Two Step Test: ''reasonably likely to come to fruition'' and ''not reasonably likely to occur.'' The Two Step Test unlinks reasonable likelihood from materiality, which may be a reason why footnote 27 of the 1989 Release states that *Basic* is inapposite to Item 303. In addition to a lower threshold than *Basic* for requiring disclosure, the 1989 Release's statement that ''the assessments made by management must be objectively reasonable'' implies a lower threshold than scienter, one akin to negligence.

Applying the Two Step Test can lead managements to have to disclose a known trend or uncertainty under the Two Step Test, even though they would not have had to do so pursuant to the words of the applicable sub-item of Item 303. Under Item 303(a)(3)(ii), disclosure is required if the trend or uncertainty is known and management reasonably expects the trend or uncertainty to have a material effect on sales, revenues or income from continuing operations. The analysis that Item 303(a)(3)(ii) requires is similar to the analysis companies make to determine materiality: a probability/magnitude analysis. Simply put, will the trend or uncertainty occur and if it does will it have a material effect? If the answer to both questions is yes, disclosure is required, and if the answer to either of the two questions is no, no disclosure is required. In contrast, the Two Step Test requires a negative analysis which can result in requiring disclosure even when the effect of the known trend or uncertainty may be immaterial. Under Step 1, no disclosure is required if management can determine that a known trend or uncertainty is not reasonably likely to occur. Under Step 2, if management cannot make the determination in Step 1, disclosure is required unless management determines that it is not reasonably likely that the known trend or uncertainty will materially affect the company's financial condition or results of operations. Step 2 requires a double negative analysis: if management cannot determine that a known trend or uncertainty will not occur, disclosure is required unless management determines that the effect of the known trend or uncertainty will not be material.

The SEC has repeated the Two Step Test in subsequent releases as applying to each sub-item of Item 303

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that references trends or uncertainties, not just to Item 303(a)(3)(ii). See 2002 Release at 4; 2003 Release at 9; Concept Release at 106-07. The 1987 Release, however, may be inconsistent with the Two Step Test. In discussing the difference between ''required disclosure'' and ''optional disclosure,'' the 1987 Release stated that, in contrast to required disclosure, ''optional-forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend, or uncertainty.'' *Id*. at 13717. Ironically, the Two Step Test as set forth in the 1989 Release, just two years after the 1987 Release, would consider ''anticipating a less predictable impact of a known event, trend or uncertainty'' as requiring disclosure when it does not meet the double negative of Step 2: management cannot reach a conclusion as to its fruition and cannot determine, if it does occur, that it won't have a material effect.

Item 303(a) has four sub-items that use the term ''trend,'' one of which, Item 303(a)(3)(ii), provides in relevant part: ''[D]escribe 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.'' Although neither Item 303 nor the SEC's other rules or regulations define the term ''trend,'' the Eleventh Circuit has explained that evaluating whether a ''trend'' exists ''require[s] an assessment of whether an observed pattern accurately reflects persistent conditions of the particular registrant's business environment'' and it ''may be that a particular pattern is, for example, of such short duration that it will not support any conclusions about the registrant's business environment.'' *See Oxford Asset Mgmt. Ltd. v. Jaharis*, 297 F.3d 1182, 1191 (11th Cir. 2002). Webster's New World Dictionary of the American Language (1955) describes the word ''uncertainty'' as ranging from a mere lack of absolute sureness to such vagueness as to preclude anything more than guesswork. The word ''uncertain'' is defined as not surely or certainly known; questionable; problematical; not sure or certain in knowledge; doubtful; vague; not definite or determined; liable to vary or change.

Management's analysis of a known trend or uncertainty must be done at the time of filing of the periodic report, not later on with the benefit of 20-20 hindsight. Furthermore, Item 303(a)(3)(ii) provides that management must reasonably expect that the known trend or uncertainty will have a material effect on net sales or revenues or income from continuing operations. Thus, under Item 303(a)(3)(ii), management may know a trend is occurring and is reasonably likely to continue into the future, but disclosure is not required unless management reasonably expects the known trend or uncertainty will have a material impact or effect on net sales, revenues or income in the future. In addition, management's analysis of the known trend or uncertainty needs to consider and may be required to disclose ''the underlying reasons or implications, interrelationships between constituent elements or the relative significance of those matters.'' 2003 Release at 9.

Although their disclosures may be overseen by the board of directors, advised on by outside counsel, and reviewed by the registrant's independent public accounting firm, these determinations are made by management. That is why Item 303 is called Management's Discussion and Analysis. Using the short-hand term ''MD&A'' can result in losing track of what the SEC intended in 1980, how the SEC has interpreted and administered the item for 37 years and how seeing the business through the eyes of management is inherently subjective and judgmental. Having the registrant's disclosure controls and procedures (''DC&Ps'') effective at a reasonable assurance level can be of great assistance in compliance, but they do not guarantee getting it right every time. In addition, premature disclosure of something as a known trend or uncertainty that turns out not to be one can be just as harmful to investors as not disclosing a known trend or uncertainty at the right time. With respect to something as complex as disclosing a known trend or uncertainty, it would not be unreasonable for management to believe that disclosure is not required because management cannot conclude that an adverse effect is reasonably possible given the uncertainty of looking into the future, although nondisclosure might not be consistent with the Two Step Test. Premature disclosure that does not turn out to be the case can have adverse effects on the company because, for every buyer in a trading market, there is a seller.

Item 303(b), which pertains to interim periods and quarterly reports on Form 10-Q, requires that ''[t]he discussion and analysis shall include a discussion of material changes in those items specifically listed in paragraph (a) of this item.'' Thus, if the registrant disclosed a known trend or uncertainty in the MD&A in its most recently filed Form 10-K, which is subject to Item 303(a), Item 303(b) would require the registrant to update that disclosure if there was a material change in the known trend or uncertainty. Instruction 3 to Instructions to Paragraph (b) of Item 303 states in pertinent part: ''[t]he discussion and analysis required by this paragraph (b) is required to focus only on material changes.''

Even though the words of Item 303(b) specifically state that it applies only to material changes, the Division in its review process applies the terms of Item 303(a) as if the filing is subject to that sub-item. Whether or not the registrant has disclosed a known trend or uncertainty in the MD&A of its Form 10-K for the preceding fiscal year, the Division's review staff requires disclosure of known trends or uncertainties in quarterly reports on Form 10-Q in accordance with the requirements of Item 303(a). The rationale for this position is quite simple: if the registrant had not disclosed a known trend or uncertainty in the MD&A of its preceding Form 10-K, having a known trend or uncertainty in a subsequently filed Form 10-Q is a material change from what was disclosed in the preceding Form 10-K.

SEC Enforcement of Item 303(a)

The SEC can enforce compliance with Item 303(a) under Section 13(a) of the Exchange Act and its associated rules, which do not create an implied private right of action. *See, e.g.*, *In re Penn Central Sec. Litig. M.D.L. Docket No. 56*, 494 F.2d 528, 540 (3d Cir. 1974); *Srebnik v. Dean*, 2006 WL 2790408 at *3 (D. Colo. Sept. 26, 2006). Three of those provisions — Section 13(a) itself, 15 U.S.C. § 78m(a) (requiring Exchange Act registrants to file reports as required by SEC rules), Rule 13a-1, 17 C.F.R. § 240.13a-1 (requiring Exchange Act registrants to file annual reports), and Rule 13a-13, 17 C.F.R. § 240.13a-13 (requiring most Exchange Act registrants

to file quarterly reports) — require on their face only that information be filed, but it is well settled that implicit in the filing obligation is the requirement that the information be truthful in all material respects. *See also* Exchange Act § 15(d), 15 U.S.C. § 78o(d) (covering reports by other issuers), Rule 15d-1, 17 C.F.R. § 240.15d-1 (covering annual reports by other issuers), and Rule 15d-13, 17 C.F.R. § 240.15d-13 (covering quarterly reports by other issuers). A fourth related provision, Rule 12b-20, mandates that, ''[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.'' 17 C.F.R. § 240.12b-20. Rule 12b-20 can result in requiring more disclosure to be provided than a specific line item would otherwise require. For example, if the line item requires the company to state the color of the sky, and the company discloses that the color of the sky is blue, Rule 12b-20 could require disclosure that, ''while the color of the sky is blue, there is a funnel cloud on the horizon that appears to be headed directly at the company's only manufacturing facility.'' Section 13(a) and the attendant rules are particularly attractive enforcement tools for the SEC because the SEC need not show scienter on the part of the issuer to prove a violation. *See, e.g.*, *SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1167 (D.C. Cir. 1978).

Section 13(a) requires public companies to file documents that conform to SEC rules, including Item 303, so that an Item 303 failing leads to a violation of Section 13(a). Thus, the SEC does not need Section 10(b) or Rule 10b-5 to enforce Item 303. As we will see from the enforcement cases discussed below, an enforcement action under Section 13(a) permits the SEC to obtain either an injunction or a cease and desist order (depending on its choice of forum) and civil money penalties, and also permits the agency to reach the responsible corporate officers as aiders and abettors or causes of an Item 303 violation. With only occasional exceptions, *e.g.*, *In the Matter of Valley Systems, Inc.*, Exchange Act Rel. No. 36227, 1995 WL 547801 (Sept. 14, 1995) (describing an Item 303 failure of cash flow disclosure in the section of the settled order that discusses Section 10(b) and Rule 10b-5) and *In the Matter of Sulcus Computer Corp.*, Exchange Act Rel. No. 37160 (May 2, 1996) (discussing an MD&A failure in the section of the settled order that discusses Sections 17(a)(2) and (3) of the Securities Act), the SEC's settled orders in Item 303 enforcement cases have been brought under Section 13(a) and the attendant rules, rather than the antifraud provisions. Even the Commission views settled orders as having ''limited precedential value.'' *See SIG Specialists, Inc.*, 58 S.E.C. 519, 537 n.36; (2005); *Carl L. Shipley*, 45 S.E.C. 589, 591-92 n.6, 1974 WL 161761 (1974); *In the Matter of BDO China Dahua CPA Co., Ltd.*, Init. Dec. Rel. No. 553 at 95 (Jan. 22, 2014), *finality order*, Exchange Act Rel. No. 74552 (March 20, 2015).

In general, both the volume and the specific content of the SEC's cases charging failures to disclose under Item 303(a) have been consistent with the use of prosecutorial discretion by the agency to pursue cases that serve the goals of the SEC's integrated disclosure program, and not to bring cases reflexively. Many of those cases — especially the ''pure'' Item 303 cases in which Item 303 is the only or the lead violation rather than an additional charge in a matter that also alleges other issues such as GAAP violations — plainly have been brought by the SEC as ''teachable moments'' for registrants.

The first enforcement case under Item 303(a) was *SEC v. The E.F. Hutton Group Inc.*, Lit. Rel. No. 10915, 1985 WL 548287 (October 29, 1985), in which the agency announced the filing of an injunctive action that defendant The E.F. Hutton Group Inc. (''Hutton'') immediately settled. The case centered on Hutton's failure to disclose (1) its increased use of its ''cash concentration'' system, which encouraged overdrafting and ''chaining'' (a form of check-kiting) that significantly reduced Hutton's need to borrow and, consequently, its interest expense in 1981, and (2) its decreased use of that system in 1982, which resulted in increases in bank borrowings and commercial paper issuances and, consequently, greater interest expense in 1982. According to the Commission, the MD&A portions of Hutton's ''1981 and 1982 Forms 10-K, which discuss the changes in net interest income from 1980 to 1981 and from 1981 to 1982, fail to identify the overdrafting practices, fail to state that the overdrafting practices constituted a material element of these changes and fail to discuss the risks and uncertainties associated with those practices, all in violation of the reporting provisions of the Exchange Act'' contained in Section 13(a), Rule 13a-1, and Rule 12b-20. In addition, the Commission included a charge that Hutton violated Rule 13(b)(2)(B) for having had insufficient internal controls in that it lacked any procedures to detect or prevent abuse of the ''cash concentration'' system.

The 1990s saw six more settlements of ''pure'' Item 303(a) cases, all brought (like *Hutton*) under Section 13(a) of the Exchange Act: *In the Matter of Caterpillar Inc.*, Exchange Act Rel. No. 30532, 1992 WL 71907 (March 31, 1992); *In the Matter of Shared Medical Systems Corp.*, Exchange Act Rel. No. 33632, 1994 WL 49960 (February 17, 1994); *In the Matter of Salant Corp. and Martin F. Tynan*, Exchange Act Rel. No. 34046, 1994 WL 183411 (May 12, 1994); *In the Matter of America West Airlines, Inc.*, Exchange Act Rel. No. 34047, 1994 WL 183412 (May 12, 1994); *In the Matter of Kemper Corp. and William R. Buecking*, Exchange Act Rel. No. 35814, 1995 WL 358038 (June 6, 1995); and *In the Matter of Sony Corporation and Sumio Sano*, Exchange Act Rel. No. 40305 (August 5, 1998). In *Caterpillar*, the Commission made the point that if a trend or uncertainty is sufficiently important to bring to the attention of a public company's board of directors, the company must be prepared to discuss it in its MD&A. *Sony* is noteworthy because it extended Item 303(a) enforcement to a foreign private issuer. In addition in *Sony*, as in *Salant* and *Kemper*, the SEC sued individual corporate officers, and not just the registrant, for Item 303 shortcomings.

The 1990s also contained a ''pure'' Item 303(a) enforcement case that the SEC litigated. On January 11, 1994, the Commission commenced an administrative proceeding against Bank of Boston that was tried to an SEC administrative law judge. *See In the Matter of Bank of Boston Corp.*, Initial Dec. Rel. No. 81 (December 22, 1995), *finality order*, Exchange Act Rel. No. 36887 (February 26, 1996). At issue in the case was the Bank's disclosure, in a single quarterly report, sur-

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rounding its provision for credit losses. The SEC did not attack the provision directly, by claiming that the number in the Bank's quarterly filing was misstated under GAAP; instead, the proof at the Bank of Boston hearing focused on the deterioration of the underlying loan portfolio and management's failure to share that information with the investing public. The administrative law judge relied heavily on the Two Step Test in the 1989 Release and on what she concluded management ''should have known'' -- which is the language of negligence liability. *See KPMG, LLP v. SEC*, 289 F.3d 109, 120 (D.C. Cir. 2002). The following passages make that clear:

> Issuance of a cease and desist order is appropriate because BOB, acting through Mr. Stepanian [BOB's Chairman and CEO], violated the Exchange Act and rules thereunder because it knew or should have known when it filed its Form 10-Q on August 10, 1989, that its financials without explanation were misleading, and that known trends and uncertainties in its real estate portfolio would reasonably be expected to have a material unfavorable impact on BOB's financial condition. Disclosure in the MD&A section of the Form 10-Q is required in situations such as this because BOB knew, or should have known, that (1) without explanation its financials were misleading, and (2) BOB's financial statements and accompanying footnotes were insufficient, without a narrative explanation, for an investor to judge the quality of earnings and the likelihood that reported financial information is not indicative of material changes in future operating results. No one who read BOB's second quarter financials in its Form 10-Q would have anticipated what management knew was highly likely to happen, and did happen, to BOB's earnings in the third quarter 1989.
>
> The 1989 Interpretative Release requires that management assess whether a known trend, demand, commitment, event or uncertainty is reasonably likely to occur. If it cannot make this determination, it must evaluate the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will occur and make disclosure unless it determines that a material effect on its financial operations or results is not reasonably likely. Applying that standard to this situation, BOB was required to disclose additional information because (1) its real estate portfolio had deteriorated significantly in value in 1988 and the first six months of 1989, and the evidence was that the deterioration was reasonably likely to continue, and (2) even if BOB could not make this determination, but assumed that the deterioration would continue, the record indicates that it was reasonable to expect that the impact on earnings would be material.

Initial Decision Rel. No. 81 at 10-11 [citations and footnotes omitted].

> The evidence is overwhelming that before August 10, 1989, Mr. Stepanian and others in top management positions at BOB, whose knowledge is imputed to BOB, knew or should have known that the future risk of loss in BOB's commercial real estate portfolio was considerably higher than was reflected from the financials for the second quarter, and that its loan loss reserve would not be sufficient to cover those losses. These persons knew, or should have known, in early August 1989 that BOB most likely would have to increase its Provision Expense substantially to add funds to its reserve and that the impact on its income statement would be material.
>
> I find that on August 10, 1989, Mr. Stepanian and BOB knew or should have known with a reasonable degree of certainty, from information supplied by four independent sources – BOB's internal reports, information from OCC and other regulators, the highly leveraged transactions in its portfolio, and New England real estate values which had declined and continued to decline substantially – that its commercial loan portfolio had deteriorated significantly in value, that deterioration was continuing, that BOB's loan loss reserve was inadequate, and that adding to it would have a material impact on earnings. I find further that BOB was required to disclose this information in the MD&A section of its Form 10-Q for the second quarter of 1989, and it did not do so.

Id. at 15-16 [footnote omitted]. The result was a cease and desist order against further violations of Section 13(a), Rule 13a-13, and Rule 12b-20, which Bank of Boston permitted to become final by not petitioning for Commission review of the ALJ's initial decision.

In *SEC v. BankAtlantic Bancorp, Inc. and Alan Levan*, Lit. Rel. No. 22229 (Jan. 18, 2012), in which Mr. Huber appeared as an expert witness for the defense, the SEC made Item 303(a)(3)(ii) allegations concerning a failure to disclose known trends relating to BankAtlantic's loan portfolio, but confined its arguments at trial to the actual words of Item 303(a)(3)(ii) and did not rely on the Two Step Test. The case ended in a defense verdict. *SEC v. BankAtlantic Bancorp, Inc.*, No-12-cv-60082 (S.D. Fla. Dec. 15, 2014) ECF No. 415.

In the past two decades, ''pure'' Item 303(a) enforcement cases, in which the only violation or the main violation charged by the SEC is failure to disclose a ''known trend or uncertainty,'' have become extremely rare. It has been far more common for the SEC to add an Item 303(a) charge in a case that mainly is about other violations. *See, e.g., SEC v. RPM International Inc. and Edward W. Moore*, Lit. Rel. No. 23639 (September 9, 2016) (partially settled, partially-litigated case regarding failure to disclose a material loss contingency relating to, or record an accrual for, a government investigation); *SEC v. Jill D. Cook and Mark C. Pierce*, Lit. Rel. No. 23367 (September 28, 2015) (litigated case involving misstated loan loss provision and allowances); *SEC v. Edward J. Woodard, Jr., Cynthia A. Sabol, CPA, and Stephen G. Fields*, Lit. Rel. No. 22587 (January 9, 2013) (litigated case regarding material understatements of allowance for loan and lease losses and underreporting of non-performing loans); *In the Matter of Southpeak Interactive Corporation and Patrice K. Strachan*, Exchange Act Rel. No. 64320 (April 21, 2011) (undisclosed related party transactions and false statements to auditors); *In the Matter of Electronic Data Systems Corporation*, Exchange Act Rel. No. 56519 (September 25, 2007) (failure to adequately disclose impact of derivatives contracts in Item 303(b), along with violations of Regulation FD); *In the Matter of Comerica, Inc.*, Exchange Act Rel. No. 52041 (July 15, 2005) (case focused on failure to record appropriate loan loss reserves); *In the Matter of Global Crossing Ltd.*, Thomas J. Casey, Dan J. Cohrs, and Joseph P. Perrone, Exchange Act Rel. No. 51517 (April 11, 2005) (insufficient disclosure of reciprocal transactions); *In the Matter of Sunbeam Corporation*, Exchange Act Rel. No. 44305 (May 15, 2001) (revenue recognition fraud in violation of Exchange Act Section 10(b) and Rule 10b-5); and *In the Matter of Larry L. Skaff and John F. Liechty*, Exchange Act Rel. No. 41313 (April 20, 1999) (numerous GAAP violations). Earlier cases taking this same approach include *In the Matter of National Partnership Investments Corp.*, Exchange Act Rel. No. 38773 (June 25, 1997) (violations of Section 10(b) and Rule 10b-9 in connection with a part-or-none offering, along with various GAAP violations).

Two notable exceptions to the general rarity of ''pure'' Item 303 cases in the past two decades are:

■ *In the Matter of Eric W. Kirschner and Richard G. Rodick*, Exchange Act Rel. No. 80947 (June 15, 2017). Kirschner and Rodick were the CEO and the CFO, respectively, of a registrant named UTi Worldwide Inc. In a settled cease and desist order, the SEC charged them with causing UTi's volation of Section 13(a), Rule 13a-13, and Rule 12b-20 by failing to include in UTi's 10-Qs adequate MD&A information to allow a meaningful assessment of UTi's financial condition and results of operations. The settlement included cease and desist orders and civil money penalties. The SEC's order reiterates the Two Step Test, as republished in the 2003 Release. Exchange Act Rel. No. 80947 at 2. In addition, the SEC's order charged respondents' inattention to Item 303 as a violation of Rule 13a-14, which mandates that CEOs and CFOs certify that their companies' quarterly filings do not ''contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading.'' *Id*. at 9. The SEC's order makes no effort to explain how such a certification – which does not address whether the company's filing is compliant with Regulation S-K – is falsified by incomplete Item 303 disclosure.

■ *In the Matter of Bank of America Corporation*, Exchange Act Rel. No. 72888 (August 21, 2014). *Bank of America* was a settled cease-and-desist proceeding in which the SEC concluded that the Bank had violated Section 13(a) and Rules 12b-20 and 13a-13 by failing to disclose in two quarterly reports ''known trends or uncertainties'' surrounding increased repurchase claims by Fannie Mae and by monoline insurers pertaining to Residential Mortgage Backed Securities. Among the facts that the Commission obliged the Bank to admit as part of the settlement were that the Bank or companies that it had acquired had made contractual representations and warranties regarding the underlying mortgage loans that they had sold to Fannie Mae or submitted to the monoline insurers for credit enhancements; that the Bank and the acquired companies generally responded to claimed breaches of the representations or warranties by evaluating whether to repurchase the loans; that Fannie Mae was taking an increasingly hard line on breaches; and that monoline claims had increased. The SEC's order cited and applied the Two Step Test. Exchange Act Rel. No. 72888 at 10. For its Item 303(a) infractions in these two quarterly reports, Bank of America was obliged to pay a civil money penalty of $20 million and to agree to a cease and desist order against further violations of Section 13(a), Rule 13a-13, and Rule 12b-20.

To be sure, in some of its releases and also in the context of litigation, the SEC has from time to time asserted the view that Item 303 violations supply a duty to disclose under Section 10(b) and Rule 10b-5. BankAtlantic, cited above, was a litigated matter in which the SEC made that assertion, albeit unsuccessfully on the facts of that case. In the main, however, the SEC's enforcement history under Item 303 has made effective use of the SEC's powers under Section 13(a) of the Exchange Act to send messages to registrants and, where needed, to obtain significant sanctions.

Part II: The Circuit Split Before the Supreme Court

In granting Leidos' petition for certiorari, the Supreme Court agreed to resolve a circuit split between the Second Circuit's decision in *Leidos* and the Ninth Circuit's decision in *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014). The Second Circuit and the Ninth Circuit each claim that its view on the existence of an Item 303 duty is consistent with the Third Circuit's decision in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), which merits discussion here both because of that disparate treatment and because it was authored by then-Circuit Judge Alito, who now sits on the Supreme Court.

Oran v. Stafford

As the earliest of the three opinions to consider Item 303 and Rule 10b-5, *Oran* wrote on the cleanest slate, although even then that slate was not quite pristine. As the *Oran* opinion notes, the Third Circuit itself had previously mentioned, but left open, the issue whether Item 303 violations create an independent cause of action for plaintiffs, *see In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1419 n.7 (3d Cir. 1997), and the Sixth Circuit had found unpersuasive the argument that a duty to disclose under Rule 10b-5 could stem from Item 303. *See In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 403 (6th Cir. 1997). In addition, the Ninth Circuit had issued a trilogy of decisions suggesting strongly that Item 303 could not be used to show a violation of Section 10(b) and Rule 10b-5. *See In re VeriFone Sec. Litig.*, 11 F.3d 865, 870 (9th Cir. 1993); *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1053 (9th Cir. 1993); *In re Convergent Techs. Sec. Litig.*, 948 F.2d 507, 516 (9th Cir. 1991).

The plaintiffs in *Oran* alleged that the defendant public company failed to make timely disclosure of the side effects of a weight-loss drug that the company produced. After weighing and rejecting plaintiffs' arguments that the information the company knew but failed to disclose was material, the court took up plaintiffs' contention that Item 303(a) obliged the defendant company to disclose what it knew about the side effects as a ''known trend or uncertainty.'' The Third Circuit first ruled that a violation of Item 303 does not create an independent cause of action for private plaintiffs. *See* 226 F.3d at 287. The court then considered whether Item 303 supplies a duty of disclosure that, if violated, would support liability under Section 10(b) and Rule 10b-5. The Third Circuit noted that the SEC's Two Step Test, discussed above, ''varies considerably from the general test for securities fraud materiality set out by the Supreme Court in *Basic Inc. v. Levinson*.'' *See id*. at 288. Accordingly, the court held that

> Because the materiality standards for Rule 10b-5 and SK-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. Such a duty to disclose must be separately shown.'' . . . We find this reasoning persuasive, and thus hold that a violation of SK-303's reporting requirements does not automatically give rise to a material omission under Rule 10b-5. Because plaintiffs have failed to plead any actionable misrepresentation or omission under that Rule, SK-303 cannot provide a basis for liability.

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Id., *quoting Alfus v. Pyramid Tech, Corp.*, 764 F. Supp. 598, 608 (N.D. Cal. 1991) [other citations and footnote omitted]. As we will see, this short paragraph would be viewed very differently by the Ninth and Second Circuits, with the Ninth Circuit focusing on the conclusion in the second sentence that a Rule 10b-5 duty to disclose must be shown separately from Item 303, and the Second Circuit perceiving, in the Third Circuit's use of the word ''automatically'' in the next sentence, an implied hole big enough to admit Item 303-based liability.

Item 303 Advances as a Staple of Securities Act Litigation

During the fourteen-year interlude between *Oran* and *NVIDIA*, a number of courts of appeals affirmed that Item 303 could trigger liability under Sections 11 and 12(a)(2) of the Securities Act of 1933. *See Silverstrand Invs. v. AMAG Pharmaceuticals, Inc.*, 707 F.3d 95, 102-03 (1st Cir. 2013); *Panther Partners Inc. v. Ikanos Communications, Inc.* (2d Cir. 2012); *Litwin v. The Blackstone Group*, 634 F.3d 706 (2d Cir. 2011); *J&R Marketing, SEP v. General Motors Corp.*, 549 F.3d 384, 390-91 (6th Cir. 2008); *see also Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998). In *Oran v. Stafford*, the Third Circuit noted that in *Steckman*, ''the court carefully limited its [Section 11/Section 12(a)(2)] holding . . ., making clear that it did not extend to claims under Section 10(b) or Rule 10b-5.'' *Oran*, 226 F.3d at 288 n.12.

Although the Supreme Court has never considered, and is not bound by, lower courts' rulings that an omission of Item 303 disclosure can be the basis for liability under Sections 11 and 12(a)(2) of the Securities Act, such liability is consistent with the structure and purpose of the Securities Act. Sections 11 and 12(a)(2) provide strictly-circumscribed remedies to plaintiffs who make claims under particular types of documents – respectively, registration statements and prospectuses. Standing is restricted to persons who purchased shares covered by a defective registration statement or who can trace their purchases directly to those shares (Section 11) or to persons who made a direct purchase of a security from a statutory seller as part of a public offering (Section 12). Within the Securities Act, Section 7 addresses the information required to be presented in registration statements, and Section 10 deals with prospectuses. Both sections refer to Appendix A of the Securities Act and to the SEC's rulemaking power to require other disclosures to be presented. Pursuant to that rulemaking power, registration statements and prospectuses must contain the information required by Regulation S-K. Sections 11 and 12(a)(2) predicate liability upon shortcomings in those particular documents, as follows:

Section 11. Section 11 liability is triggered if a registration statement supporting the issuance of securities ''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'' [emphasis added]. Because registration statements must comport with Regulation S-K, Item 303 information is ''required to be stated therein'' and thus must be disclosed.

Section 12. As relevant here, Section 12(a)(2) provides liability for anyone who offers or sells a security by the use of ''a prospectus or oral communication'' that ''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.'' Section 12(a)(2) differs from Section 11 because it lacks language about omissions of material facts ''required to be stated'' in a particular document (and in that respect more closely resembles Rule 10b-5). However, in the Section 12 context this difference in language leads nowhere because, at least since 1995, it has been clear that Section 12(a)(2) only applies to prospectuses, which in turn equate to statutorily-defined registration statements. In *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995), the Supreme Court held that (1) the ''oral communication'' described in Section 12(a)(2) must be an oral communication that relates to a prospectus, *id*. at 567-68, and that (2) a prospectus for Section 12(a)(2) purposes can only be a document that ''contain[s] the information contained in the registration statement,'' *id*. at 568-69. Thus, if a registration statement would be deficient because it lacked Item 303 information, which is required by Part I of the registration statement form, the prospectus that is Part I of the registration statement will be deficient for the same reason. Several lower courts have held that that deficiency, in turn, will supply a ground for liability under 12(a)(2). *But see* Securities Offering Reform, Securities Act Rel. No. 8591 (Dec. 1, 2005) at 175 (''Securities Act Section 12(a)(2) and Section 17(a)(2) do not require that oral statements or the prospectus or other communications contain all information called for under our line-item disclosure rules or otherwise contain all material information.'') The understanding of Section 12(a)(2) as being violated by a prospectus that lacks required disclosure is buttressed by the ''loss causation'' provision that was added to Section 12(b) as part of the Private Securities Litigation Reform Act of 1995. Section 12(b) brings Section 12(a)(2) further into line with Section 11 by restricting Section 12(a)(2) liability to ''the depreciation in value of the subject security resulting from such part of the prospectus or oral communication . . . not being true or omitting to state a material fact *required to be stated therein* or necessary to make the statement not misleading'' [emphasis added].

Just as they did with the Third Circuit's language in *Oran*, the Ninth Circuit and the Second Circuit drew radically different conclusions from the courts' acceptance of Section 11/Section 12 liability based on Item 303.

NVIDIA

The *NVIDIA Corporation Securities Litigation* involved claimed nondisclosure of defects in semiconductor products. Plaintiffs argued that NVIDIA should have disclosed what it knew about the defects as a ''known trend or uncertainty'' under Item 303. Concluding that its own prior decisions suggested, but did not squarely hold, that an Item 303 violation cannot support a violation of Section 10(b) and Rule 10b-5, the Ninth Circuit turned to the Third Circuit's materiality-based analysis in *Oran*, which it found both persuasive and conclusive. 768 F.3d at 1054-55. The court also firmly rejected plaintiffs' argument that precedent under Sections 11 and 12 of the Securities Act supported finding an Item 303 duty under Section 10(b) and Rule 10b-5, noting that, unlike Sections 11 and 12, Section 10(b) and Rule 10b-5 impose no affirmative disclosure requirements,

and that, under Supreme Court precedent, ''for purposes of Section 10(b) and Rule 10b-5, material information need not be disclosed unless omission of that information would cause other information that is disclosed to be misleading,'' *id*. at 1056, *citing Matrixx Initiatives v. Siracusano*, 563 U.S. 27, 44 (2011).

Leidos

From the Second Circuit's point of view, its holding in *Leidos* that Item 303 can supply a duty to disclose for purposes of Section 10(b) and Rule 10b-5 was anticlimactic because it had made the identical ruling more than a year earlier in *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015). Despite the reasons, discussed above, to treat Section 12(a)(2) differently from Section 10(b) and Rule 10b-5, the Second Circuit began and ended its discussion of Item 303 and Rule 10b-5 in *Stratte-McClure* with citations to its recent Securities Act decisions and the observation that Section 12(a)(2) and Rule 10b-5 both require disclosure of 'material fact[s] necessary in order to make . . . statements made . . . not misleading.' '' 776 F.3d at 102, 104. The court also cited four appellate decisions for the proposition that ''a duty to disclose under Section 10(b) can derive from statutes or regulations that obligate a party to speak,'' even though each of those opinions was, at best, speaking in dictum about a possible breach of duty. *Id*., citing *Glazer v. Formica Corp.*, 964 F.2d 149 (2d Cir. 1992) (the reference is apparently to page 157, where *Glazer* cites *Backman*, below, for the general proposition that there may be a ''statute or regulation requiring disclosure''); *Backman v. Polaroid Corp.*, 910 F.2d 10, 20 (1st Cir. 1990) (the court's citation is to the dissenting opinion in the case, which only referred to the possibility that ''a statute or regulation [might] require[] disclosure''); *Oran v. Stafford* (where, as noted above, the court found no duty to disclose); and *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir. 2001) (in which the court did consider the possibility that ''known trends or uncertainties'' could give rise to a duty to speak, but decided that the trend at issue was not known to the registrant at the time its Form 10-K was issued).

The *Stratte-McClure* court could not specifically relate Item 303 to any specific requirement of the statutory provision – Section 10(b) – that it was construing. (If the SEC wished to add a requirement for disclosure of ''known trends and uncertainties'' under Section 10(b), it presumably could do so by issuing an appropriate rule under Section 10(b) itself, as it did by prohibiting certain representations in securities offerings (see Rule 10b-9) and requiring disclosure of credit terms in margin transactions (Rule 10b-16). The agency has made no move in that direction, relying instead on provisions other than Section 10(b) as the authority for its MD&A requirements (see Part I above).)

The Second Circuit also tried to classify an Item 303 omission as a ''half-truth'' by making the questionable observation – supported by a single sentence in a law review article – that a reasonable investor reading a Form 10-K or Form 10-Q would know that such a filing is supposed to contain Item 303 disclosure and, if a particular trend or uncertainty did not appear, would reasonably infer its nonexistence. 776 F.3d at 102, *citing* Donald C. Langevoort and G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L.REV. 1639, 1680 (2004). The Second Circuit also cited as support for its holding a settled SEC enforcement case that described an Item 303 failure as a violation of Section 10(b) and Rule 10b-5. *See* 776 F.3d at 102 n. 5, citing *In the Matter of Valley Systems, Inc.*, Exchange Act Rel. No. 36227 (Sept. 14, 1995); see discussion of SEC enforcement cases in Part I above.

The conclusions that Item 303 supplies a Rule 10b-5 duty to disclose and that the defendant had breached that duty did not end the Second Circuit's work in *Stratte-McClure*. Having come that far, the Second Circuit addressed the other elements of a Rule 10b-5 claim. First up was materiality. Here, the Second Circuit returned to *Oran v. Stafford*; noting the Third Circuit's observation that Item 303 requires a lesser standard of materiality than that mandated by *Basic Inc. v. Levinson*, the court held that a plaintiff who wished to predicate a Rule 10b-5 claim on Item 303 must meet the more rigorous *Basic* test to prevail on its claim. The Second Circuit used this requirement – which it assumed *Stratte-McClure* could meet – to attempt to square its Item 303 ruling with *Oran*. 776 F.3d at 103. Specifically, the Second Circuit interpreted the Third Circuit's use of the word ''automatically'' in *Oran* (''a violation of SK-303's reporting requirements does not automatically give rise to a material omission under Rule 10b-5,'' 226 F.3d at 288) to mean that the Third Circuit would be comfortable with an Item 303-based duty so long as the *Basic* materiality requirement was overlaid on it.

Finally, the Second Circuit addressed scienter. Here, plaintiff's claims foundered because the Second Circuit concluded that the complaint did not give rise to a strong inference of scienter. 776 F.3d at 106-109. Defendant having prevailed on scienter (and thus in the litigation), there was no one to petition for certiorari on the ''Item 303 duty'' aspect of *Stratte-McClure*, and the case ended.

In *Leidos*, unlike in *Stratte-McClure*, the defendant was not the prevailing party. The plaintiffs claimed that Leidos had waited too long to disclose what it knew about its exposure to liability for its employees' fraud in connection with Leidos' contracts with New York City. Plaintiffs pleaded those claims under two different theories: non-compliance with GAAP by failing to disclose appropriate loss contingencies associated with the contract, in violation of Financial Accounting Standard No. 5 (''FAS 5,'' now Financial Accounting Standards Board Accounting Standards Codification Topic 450-20), and failure to disclose the underlying facts as a known trend or uncertainty under Item 303(a)(3)(ii). The Second Circuit agreed with plaintiffs on both theories. (Leidos did not seek certiorari with respect to the FAS 5 theory, so no matter what the Supreme Court may decide about Item 303, the *Leidos* litigation will continue.) With respect to Item 303, the court of appeals did not re-cover the ground that it had trodden in *Stratte-McClure*, but did helpfully decide that a ''known trend or uncertainty'' must be actually known to management, and that it is not enough that management ''should have known'' of it. 818 F.3d at 95.

Less helpfully, the court took away much of the benefit of its requirement that an Item 303-based claim must satisfy the materiality requirements of *Basic* by reemphasizing that a securities complaint '' 'may not properly be dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable

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investor that reasonable minds could not differ on the question of their importance.' '' ***Id***. at 96, ***quoting ECA, Local 134 IBEW Joint Pension Tr. Of Chi. v. JP Morgan Chase Co.***, 553 F.3d 187, 197 (2d Cir. 2009) and ***Ganino v. Citizens Utils. Co.***, 228 F.3d 154, 162 (2d Cir. 2000). The gossamer protection for defendants that is provided by the Second Circuit's materiality requirement for Item 303-based claims is further illustrated by the same court's discussion of materiality in ***Litwin v. Blackstone Group, L.P.***, where the court noted that ''even at the summary judgment stage, the 'determination [of materiality] requires delicate assessments of the inferences a ''reasonable shareholder'' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.' '' 634 F.3d at 717, ***quoting TSC Indus., Inc. v. Northway, Inc.***, 426 U.S. 438, 450 (1976). Essentially, the Second Circuit is saying that, to benefit from the materiality requirement, the defendant must stand trial.

Observations on the Circuit Split

The Second Circuit's innovation in *Stratte-McClure* and *Leidos* lay in treating *omissions* of Item 303 disclosures as breaches of a duty to disclose under Rule 10b-5. Until *Stratte-McClure* and *Leidos*, liability for Item 303 omissions was confined to SEC enforcement actions, generally brought under Section 13(a) of the Exchange Act, and to private actions involving public offerings of securities under Sections 11 and 12 of the Securities Act. This state of the law made sense from the standpoint of statutory coverage, because Section 13(a) of the Exchange Act and Sections 11 and 12 of the Securities Act are all focused on an issuer's or a registrant's compliance with SEC filing requirements, which include completeness under Regulation S-K. Rule 10b-5, in contrast, does not predicate liability on documents that merely are incomplete. Instead, absent a fiduciary-like ''relationship of trust and confidence between parties to a transaction,'' *see Chiarella v. United States*, 445 U.S. 226, 230 (1980), Rule 10b-5 only requires disclosure of material information ''when necessary 'to make . . . statements made, in the light of the circumstances under which they were made, not misleading.' '' *Matrixx Initiatives v. Siracusano*, 563 U.S. at 44. This does not immunize false Item 303 disclosures; under *Matrixx*, if a company affirmatively discusses a trend or uncertainty in its MD&A (or anywhere else in its disclosure documents), that discussion must be truthful, and the company may not knowingly or recklessly omit from that discussion any material facts that are needed to prevent that discussion from being misleading. Nor can an Item 303 omission shield a company from Rule 10b-5 liability that otherwise would exist; if a company's SEC filings not only violate Item 303, but also, for example, materially violate GAAP (as with many of the SEC enforcement cases discussed above), a Rule 10b-5 case may be brought over the GAAP violation. However, under pre-*Stratte-McClure* law, an Item 303 omission is not a sword in the hands of a Rule 10b-5 plaintiff.

The Second Circuit's holding that Item 303 creates an affirmative duty to disclose under Rule 10b-5 supplies that sword and is very difficult to square not only with the language of Rule 10b-5, but also with prior Supreme Court authority.

First, particularly if the Supreme Court were to accept the Second Circuit's view in *Stratte-McClure*, which the *Leidos* court followed, that any omission of required disclosure constitutes a ''half-truth,'' it would render almost meaningless the Supreme Court's statement in *Matrixx* that ''[e]ven with respect to information that a reasonable investor might consider material, companies can control what they have to disclose under these provisions by controlling what they say to the market.'' *Id*. at 45. *Stratte-McClure* and *Leidos* contain no stopping point that would prevent *all* of the SEC's disclosure rules from being incorporated into Rule 10b-5, potentially swamping companies' control over what they say with extraneous information such as inconclusive judgment calls as to the probability of a material adverse outcome to a trend or uncertainty. It is true, of course, that, since SEC rules oblige public companies to make certain kinds of disclosures, those requirements would remain in place even if *Leidos* is reversed. But as we demonstrate in Part III below, Rule 10b-5 liability will inevitably spur ''defensive'' disclosure that otherwise would not happen and that, once made, will multiply the areas in which public companies find themselves speaking.

Second, the notion that a reasonable investor would observe and rely on the absence of particular ''trend or uncertainty'' disclosure and conclude, based on that absence, that that trend or uncertainty did not exist, *see Stratte-McClure*, 776 F.3d at 102, stretches the concept of the ''reasonable investor'' beyond recognition. To be sure, omissions analysis ''brings the reasonable person into the analysis, and asks what she would naturally understand a statement to convey beyond its literal meaning.'' *See Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, __ U.S. __, 135 S.Ct. 1318, 1331-32 (2015). It is fair to assume certain background knowledge by a reasonable investor who is reading an SEC filing, such as conversancy with the English language, or the understanding that the financial statements in that filing are based upon GAAP, or even, as the Supreme Court noted in *Omnicare*, ''the customs and practices of the relevant industry.'' 135 S.Ct. 1330. It is quite another thing – and quite counterintuitive -- to assume that the reasonable investor has an SEC disclosure lawyer's conversancy with all of the particular requirements for SEC filings and the SEC's glosses on those requirements, and thus has the ability to notice the absence of an Item 303 disclosure.

The evidence available on the SEC's Website regarding what a reasonable investor would know, or might assume, from reading an SEC filing does not suggest that level of discernment. The ''Mandatory Disclosure Documents Telephone Survey,'' a July 30, 2008 report by Abt ARBI that was commissioned by the SEC's Office of Investor Education and Advocacy, concluded that many investors do not read disclosure documents. *See* http://www.sec.gov/pdf/disclosuredocs.pdf at iv. Of those who said they received annual reports, over half said that they rarely, if ever, read them. (*Id*. at 12.) Among the investors who read annual reports, only 9% said that they typically look for the MD&A. (*Id*. at 17.) The Executive Summary of the Survey, noting investor confusion about the intended contents of SEC disclosure documents in general, observed that ''[i]n light of this, it is not enough to simply clear up the language and reduce the legal jargon in the disclosure documents. It needs to be made clear to investors what key

information is contained in each document.'' (*Id*. at iv.) As regards the MD&A, the SEC's Website guidance for investors on ''How to Read a 10-K'' is less than helpful in assessing what a reasonable investor should understand; that guidance explains that the MD&A must disclose ''any known trends or uncertainties that *could* materially affect the company's results'' [emphasis added], which is a different trigger for disclosure than those set forth in either Item 303 or the Two Step Test. (*See* http://www.sec.gov/fast-answers/answersreeda10khtm.html (July 1, 2011).) And even if a reasonable investor noticed the absence of a disclosure about a trend or uncertainty, that reasonable investor would be unable to conclude that the trend or uncertainty in question did not exist, as opposed to being extant but unknown to the registrant's management, or being extant and known to management but not reasonably likely to have a material impact on the registrant's operations.

Third, although it was helpful of the Second Circuit to hold in *Leidos* that ''known,'' in the phrase ''known trend or uncertainty,'' means actually known to management, the application of a scienter-based provision like Rule 10b-5 to management's assessment of the ''known trend or uncertainty'' under Item 303 is not so simple. The example of possible tornado damage to a registrant's factory may help make the point. *Leidos* plainly requires that, to violate Item 303 with respect to the risk or uncertainty posed by a particular tornado, management must actually have seen (or otherwise learned of) a funnel cloud on the horizon; the fact that management should have looked out the window, but did not, will not suffice.

However, seeing the funnel cloud is only the predicate to an Item 303 violation; once management has seen the funnel cloud, the SEC expects it to apply the Two Step Test, which goes beyond the language in Item 303, to assess whether the trend or uncertainty represented by the funnel cloud is reasonably likely to come to fruition (is it actually a tornado and is it heading toward the factory?) and, if management cannot determine that it is not reasonably likely to materialize, to ''evaluate objectively'' the consequences of the known trend or uncertainty on the assumption that it does come to fruition and then disclose it ''unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur'' (is the storm severe, and is the factory resilient?). The 1989 Release couches each of these determinations in terms of what is ''reasonable,'' invoking the classic ''reasonable person'' standard of negligence cases. But negligence was rejected as a basis for Rule 10b-5 liability more than forty years ago. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976) (holding that Rule 10b-5 claims require scienter, defined as ''a mental state embracing intent to deceive, manipulate, or defraud'').

If there were any doubt about the mental state contemplated by the SEC's 1989 Release, the Release itself notes that ''[e]ach final determination resulting from the assessments made by management must be *objectively reasonable*, viewed as of the time that the determination is made.'' 1989 Release at 7 [emphasis added]. Scienter, in contrast, is a mental state, which is inherently subjective; the defendant must be proved either to have known what he was doing, or at least to have acted recklessly – defined not as a heightened form of negligence, but as ''an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'' *In re Alpharma Inc. Securities Litigation*, 372 F.3d 137, 148 (3d Cir. 2004). The management determinations required by Item 303, as construed in the SEC's 1989 Release and in *Bank of Boston* (the only ''pure'' Item 303 case that the SEC has litigated) plainly are designed to be evaluated under a negligence standard, which works well for non-scienter statutes such as Sections 11 and 12 of the Securities Act or Section 13(a) of the Exchange Act, but does not work at all for Rule 10b-5. It is possible, of course, to patch over this gap by adding a requirement that the plaintiff in a Rule 10b-5 case based on Item 303 must show Rule 10b-5 scienter and not just negligence, just as *Stratte-McClure* did with materiality by superimposing *Basic v. Levinson* on Item 303, which requires something less than materiality under the 1989 Release. Indeed, the *Stratte-McClure* court may have done exactly that when it ruled that the plaintiff there failed to show adequate scienter by the defendant in that case. But at some point such patches become the legal counterparts of the epicycles (circles on circles) that our ancestors added to their earth-centered model of the universe in an effort to account for the observed movements of the planets – less a rational adaptation of the model than a demonstration that the model (in this case, equating the requirements of Regulation S-K with Rule 10b-5 duties to disclose) does not make sense. And as we show in Part III below, it is also true that the assessments demanded of management by Item 303 and the 1989 Release inevitably will be opinions of management which will not even be false (let alone knowingly or recklessly false) unless a plaintiff can prove that the opinion was not genuinely held under *Omnicare*; the substitutes for such proof that the Court pointed to in *Omnicare* (statements of fact embedded in the opinion, or a reasonable investor's inference, from the opinion itself, that it must have a basis) will not, by definition, be available in the context of an opinion that justified an omission of disclosure.

Fourth, another reason (in addition to statutory language) why the conclusion that Item 303 can support liability under Sections 11 and 12 does not lead to the same conclusion for Section 10(b) and Rule 10b-5 is that Sections 11 and 12 are express liability provisions established by Congress, whereas private claims under Section 10(b) and Rule 10b-5 are judicially-implied creations that, at most, were acknowledged by Congress when it passed the Private Securities Litigation Reform Act in 1995. The Supreme Court cautioned in *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc.*, 552 U.S. 148, 165 (2008) that ''[t]hough it remains the law, the § 10(b) private right should not be extended beyond its present boundaries.'' As this article makes clear, the use of Item 303 (let alone the myriad other SEC rules that would logically follow with it, as well as future rules adopted to respond to emerging issues and the increasing complexity of financial reporting) to create a new disclosure duty under Rule 10b-5 would be just such an extension.

Finally, while we recognize that ''[p]olicy considerations cannot override . . . the text and structure of the [Exchange] Act,'' *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994), and that ''Congress gets to make policy, not the

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courts,'' *Omnicare*, __ U.S. at __, 135 S.Ct. at 1331, this is a case in which the text and structure of the law and public policy are fully consistent. As we show above and below, the pre-*Stratte-McClure* understanding of the law served policy objectives by limiting the damage private litigants might do to the SEC's objectives in promulgating Item 303 in the first place, and also by limiting the distortive effect that private liability might have on registrants' disclosure decisions not only under Item 303, but under other SEC rules adopted under Sections 13(a), 15(d), and perhaps 14(a) rather than the antifraud provisions. Both law and policy lead to the conclusion that the Second Circuit's Item 303 ruling in *Leidos* should be reversed.

Part III -- The Consequences of an Item 303-Based Duty to Disclose

In this section, we discuss the impact that Supreme Court affirmance of *Leidos* would have on: (a) how management approaches the disclosure of known trends or uncertainties under Item 303(a); and (b) how an affirmance of *Leidos* can be expected to affect the disclosure required by other sub-items of Item 303 and by other items of Regulation S-K, as well as other SEC rules.

Disclosure Under Item 303(a)

As discussed in Part I, when it adopted Item 303, the SEC wanted to replace the check-the-box, mechanistic disclosure of Guides 1 and 22 with meaningful disclosure. To accomplish this goal, the SEC adopted a flexible, general, principles-based rule to give public company managements the opportunity to tell their stories. MD&A has been a challenging task for both managements of public companies and the SEC. To provide guidance on what the SEC has in mind, it has issued over a dozen interpretive releases over the past 37 years. Despite the challenges, the SEC has never abandoned the flexible, principles-based approach that Item 303 established, presumably because the agency continues to believe that an MD&A that enables shareholders to see the business through the eyes of management results in more meaningful information to shareholders and the investing public than a more prescriptive, check-the-box standard would provide. Simply put, MD&A remains the core narrative discussion about the financial statements and what management thinks about its current performance as an indicator of what future results might be.

As we note above, it is clear under existing law that if a company affirmatively discloses a trend or uncertainty in its MD&A, that disclosure must be truthful, and the company may not knowingly or recklessly omit from that disclosure any material facts that are needed to prevent the discussion of that trend or uncertainty from being misleading. Affirmance of the Second Circuit's view in *Stratte-McClure*/*Leidos* that Item 303(a)(3)(ii) creates a freestanding duty, actionable under Rule 10b-5, to disclose wholly-omitted information, or that the omission of any information required in a disclosure document constitutes a ''half-truth'' under Rule 10b-5, has the potential to result in significant litigation in which plaintiffs allege violations with 20-20 hindsight and in which disclosure documents, and in particular disclosure in MD&A, become a trap for the unwary. We believe that public companies would understand that risk and adapt to it. That adaptation would likely represent a fundamental change in how managements perceive MD&A and how they comply with Item 303(a)(3)(ii).

Under *Leidos*, a plaintiff need only allege that a company violated an SEC disclosure rule, such as Item 303, and acted with scienter and that the violation was material. *Leidos* states that Item 303 requires disclosure of ''the manner in which th[at] then-known trend [ ], event[ ],or uncertaint[y] *might* reasonably be expected to materially impact [Leidos'] future revenues'' [emphasis added]. *Leidos*, 818 F.3d at 96, citing *Litwin v. The Blackstone Group, L.P.*, 634 F.3d at 719. Item 303, on the other hand, requires disclosure of a trend or uncertainty that ''the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations'' [emphasis added]. A *might* standard would trigger more disclosure than a *will* or *would* standard. Thus, under *Leidos*, a plaintiff could simply claim that a company omitted disclosure about a trend or uncertainty that management reasonably expected might have a material impact on the company's future liquidity, capital resources or revenues. Since a plaintiff will only bring such a lawsuit when a company has had a significantly adverse outcome to a trend or uncertainty, the plaintiff is likely to be able to sufficiently allege the materiality of the omission to withstand a motion to dismiss the complaint. And as noted in Part II above, courts generally do not dismiss a complaint, or grant summary judgment, based on a defendant's claim that an omission is not material, so that lack of materiality is unlikely to save a defendant from having to go to trial, or settle the case. While, presumably, a plaintiff would also have to make plausible allegations that the company acted with the requisite scienter when it violated a disclosure rule, such as Item 303, that, too, may not be very difficult when the plaintiff alleges that management knew about the trend or uncertainty at the time of filing and the company's performance or financial condition has already been affected in a materially adverse way by the outcome of a known trend or uncertainty.

An affirmance of *Leidos* would not make registrants' crystal balls into the future any clearer and the assessment of the need for disclosures about trends and uncertainties would remain very difficult. In light of those difficulties, companies would likely take a defensive approach in drafting MD&A. Rather than MD&A being approached as an opportunity for management to tell its story and to seek to enable investors to see the company through the eyes of management, management would approach MD&A as requiring a check-the-box approach and defensive disclosures given the potential risk of an expensive class action related to an omission of material information. The Rule 10b-5 risk related to trends and uncertainties would require far more rigorous procedures to effectively identify and evaluate any possible trends and uncertainties and to draft more protective discussions about any disclosed trend or uncertainty because an adverse impact is reasonably possible or disclosure is required under the Two Step Test.

In general, one can expect managements to change the way in which they exercise their judgment from seeking disclosure that enables investors to see the business through the eyes of management to disclosing

information that is intended to protect the company from the risk of liability. Such a change would likely increase the costs and burdens of compliance without providing meaningful disclosure to investors. Today, the drafting of MD&A is often controlled by the accounting staff under the supervision of the controller or the chief financial officer with input from the disclosure committee and attorneys. Drafting takes into account information from various parts of the company as well as information that management has communicated to the board of directors. In a post-*Leidos* affirmance environment, lawyers would likely play a much more significant role than today and MD&A would look much less like management telling its story. Not only would companies need to conduct more rigorous searches for and evaluations of possible trends and uncertainties; they also would need to involve outside disclosure and litigation counsel to a much greater extent because of the concern that an omission could lead to the significantly higher risks relating to a Rule 10b-5 class action for monetary damages than the risk of an action for an injunction or a cease and desist order brought by the SEC to enforce its rules. Companies would need to draft reports under the Exchange Act in the same manner that they draft registration statements and prospectuses, with full awareness of the Rule 10b-5 risk. Companies' disclosures about trends and uncertainties would increase. MD&As would become longer, more complex and defensive.

Longer and more complex disclosures would be even less readable and provide limited additional meaningful information to investors. The risk of material information being obscured would increase, leading to ''disclosure overload.'' *See, e.g.*, Speech by then Commissioner Troy A. Paredes, Remarks at the SEC Speaks in 2013 (Feb. 22, 2013) available at https://www.sec.gov/news/speech/2013-spch022213taphtm. In his first public address, SEC Chairman Jay Clayton observed that over the past two decades ''studies show the median word-count for SEC filings has more than doubled, yet readability of those documents is at an all-time low. SEC Chairman Jay Clayton, Remarks at the Economic Club of New York, 1 (July 12, 2017) (''Chairman Clayton's Speech'') available at https://www.sec.gov/news/speech/remarks-economic-club-new-york. As support for this statement, footnote 8 of Chairman Clayton's Speech at 7 cites Travis Dyer, Mark Lang, Lorien Stice-Lawrence, ''The Evolution of 10-K Textual Disclosure Evidence from Latent Dirichlet Allocation'' (October 2016) and the SEC Office of the Investor Advocate, ''Report on Objectives: Fiscal Year 2017,'' 5 (June 30, 2016), available at https://www.sec.gov/advocate/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2017.pdf. Ironically, if public companies respond to an affirmance of *Leidos* by disclosing more information, it could defeat the SEC's purpose in adopting Item 303 of investors seeing the business through the eyes of management. Instead of seeing the business through the eyes of management, investors would see a plethora of information disclosed to avoid potential liability. In contrast, if the Supreme Court were to reverse *Leidos*, public companies and their legal advisors that have begun to prepare for a *Leidos* affirmance by disclosing more information about trends and uncertainties would revert to the status quo ante.

If the Supreme Court affirms *Leidos*, the decision may also agree with *Stratte-McClure* (the underpinning of *Leidos*) that the Item 303-based duty involves the application of the Two Step Test. In that event, public companies would need to review their DC&Ps. To be sure that their DC&Ps are consistent with the Two Step Test, registrants would need to have policies and procedures in place and operating at a reasonable assurance level to identify, evaluate and disclose all trends and uncertainties that might adversely affect them in the future. DC&Ps are defined in Rule 13a-15(a) under the Exchange Act as controls and procedures ''that are designed to ensure'' that a company complies with the disclosure requirements applicable to reports and other documents filed under the Exchange Act. It is likely that registrants would need enhanced DC&Ps designed to ferret out all trends and uncertainties, including those that previously were omitted as not being required because management could not conclude that it was reasonably possible that they would adversely affect the company's liquidity, capital resources or results of operations. In addition, the drafting of appropriate disclosures about known trends and uncertainties might involve new and rigorous review processes and would have to involve all of the relevant participants.

With respect to identifying trends and uncertainties, a company might start with the risks identified in the preceding year's Annual Report on Form 10-K and all operational events and plans that might affect the company's future profitability. Particularly after the SEC's recent enforcement case *In the Matter of Kirschner* and *Rodick*, discussed in Part I above, a company might want to consider amending sub-certifications from employees to elicit information about trends and uncertainties that middle-level managers are seeing in the company's operations. The list of possible trends and uncertainties may include any that management has reported to the board of directors or that management is monitoring, including as a result of the company's enterprise risk management process. Involvement by the senior management and the board of directors in the identification of trends and uncertainties would be even more important in a post-*Leidos* affirmance environment than it is today because of the risk of Rule 10b-5 liability for omissions of disclosure about known trends and uncertainties. After the identification process is complete, each trend and uncertainty that has been identified would have to be evaluated.

The evaluation of possible trends and uncertainties with a view to whether disclosure should be made would require a company, including the disclosure committee, to assess each identified trend and uncertainty to determine whether the trend or uncertainty is reasonably likely to materially affect the company's liquidity, capital resources or results of operations. Affirmance of *Leidos* would require companies to evaluate trends and uncertainties under the Two Step Test whenever they cannot conclude that the trend or uncertainty is reasonably likely to materially affect the company's liquidity, capital resources or results of operations. This process would require more intense participation by lawyers because of the highly judgmental evaluation required by that test and the risk of a class action suit involving an omission to disclose a known trend or uncertainty that is brought by a plaintiff with the benefit of hindsight. Given the potential liability that companies may face in the post-*Leidos* environment, as described above, it is unlikely that management would be able to conclude that many of the trends or uncer-

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tainties that remain on its list for evaluation under the Two Step Test can be excluded under the first step of the Two Step Test, viz. they are not reasonably likely to occur. Therefore, the company would need to assess under the second step of the Two Step Test whether, assuming that the trend or uncertainty occurs, it is not reasonably likely to have a materially adverse effect on the company. The second step requires disclosure unless management concludes that the outcome of the trend or uncertainty is not reasonably likely to be material. In light of the potential Rule 10b-5 liability for failure to disclose a trend or uncertainty, we believe that registrants would err on the side of more disclosure about trends and uncertainties. This defensive application of the Two Step Test would result in a discussion intended to avoid liability rather than a discussion and analysis focused on providing investors ''the opportunity to look at the company through the eyes of management,'' as explained in the 1987 Release. 1987 Release at 13717. Whether a company would also have to consider the likelihood of a materially adverse effect of a trend or uncertainty on its results, liquidity or capital resources based on the ''might'' standard articulated in *Leidos* or the ''could'' standard articulated on the SEC's Website would depend on what the Supreme Court says in any opinion that affirms *Leidos*.

The drafting of the disclosure about each known trend or uncertainty that must be disclosed would also involve a more rigorous and time-consuming process by management than the principles-based process of today and would require the involvement of more people. The process would be intended to craft disclosure that does not unduly alarm investors, but, at the same time, does not unduly minimize the extent of the outcome of the disclosed trend or uncertainty. The process would also need to consider any prejudice on the outcome of any related litigation or other conflict situations or any competitive harm. In addition, the drafting process would need to consider the accounting and financial statement disclosure consequences of the additional disclosures about known trends or uncertainties.

The Rule 10b-5 risk would also result in more attention to the Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, __ U.S. __, 135 S.Ct. 1318 (2015) and to the safe harbors for forward-looking statements. Even though *Omnicare* was decided under Section 11 of the Securities Act, the decision can protect any opinions articulated in the MD&As of periodic reports. *See* L. Griggs, J. Huber, C. Mixter, ''Omnicare and GAAP-Based 'Numerical Opinions,' '' 47 SRLR 1293 (June 29, 2015); L. Griggs, J. Huber, C. Mixter, ''The SEC's Renewed Interest in Accounting Cases – A New Beginning or a Victim of *Fait*?'', 45 SRLR 1663 (Sept. 16, 2013). To obtain that protection, however, the disclosure should make clear that the outcome of both trends or uncertainties that are disclosed and those that are not disclosed are opinions. In addition, the disclosure should identify any forward-looking statements in the disclosure, such as the statements about the possible outcome of a trend or uncertainty, and describe the assumptions underlying management's judgment on the future impact of the trend or uncertainty on the company so that the company has the benefit of the safe harbor rule for forward-looking statements. Section 21E of the Exchange Act provides protection from liability for a forward-looking statement made by a company subject to the reporting requirements of the Exchange Act provided that the forward-looking statement is identified as a forward-looking statement and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.

Finally, while a company's goal may be to draft disclosure about known trends or uncertainties that is transparent, balanced, and as useful to investors as possible, it may be a difficult goal to achieve because the disclosure is likely also to be complex and uncertain, given the nature of trends and uncertainties. Therefore, the disclosure would likely be of somewhat limited value to an investor trying to assess the likely impact of the trend or uncertainty on the company's future liquidity, capital resources or results of operations. As managements draft increasingly defensive disclosure to respond to affirmance of *Leidos*, the expanded disclosures may cause plaintiffs to claim that the companies violated the ''buried facts'' doctrine of Rule 10b-5. *See Werner v. Werner*, 267 F.3d 288, 298 (3d Cir. 2001) (describing doctrine); *Kas v. Financial General Bankshares, Inc.*, 796 F.2d 508, 516 (D.C. Cir. 1986) (describing the doctrine as providing that '' '[f]ull and fair disclosure cannot be achieved through piecemeal release of subsidiary facts which if stated together might provide a sufficient statement of the ultimate fact,' '' citing *Kennedy v. Tallant*, 710 F.2d 711, 720 (11th Cir. 1983), but as requiring ''*some* conceivable danger that the reasonable shareholder would fail to realize the correlation and overall import of the various facts interspersed throughout the proxy'' [emphasis in original]). So a balancing of potential competing Rule 10b-5 claims may be needed. Moreover, the disclosure of more known trends and uncertainties can result in more questions from analysts on earnings calls as well as competitive issues with other companies that have businesses in the same or similar segments, whether they are publicly or privately held.

In short, affirmance would increase the time that public companies spend on preparing disclosures about trends and uncertainties in MD&A, increase the related costs, and increase the amount of information about such trends and uncertainties, potentially overwhelming investors with so much disclosure that they are unable to fully assess which trends or uncertainties are really important to their investment decision. These negative results would outweigh any benefits of greater attention to disclosures about trends and uncertainties resulting from an affirmance by the Court of *Leidos*. The unanticipated effects of such a decision may include fewer companies making initial public offerings and more companies determining to go private to avoid the risk of management being second guessed in litigation that can expose the company to enterprise-threatening litigation. SEC Chairman Clayton has noted that ''[i]ncremental regulatory changes may not seem individually significant, but, in the aggregate, they can dramatically affect the markets,'' and '' the roughly 50% decline in the total number of U.S.-listed public companies over the last two decades forces us to question whether our analysis should be cumulative as well as incremental.'' Chairman Clayton's Speech at 2. When Item 303 was adopted in 1980, there were approximately 12,500 registrants reporting to the SEC under the Exchange Act. Magnifying the effect of MD&A by

engrafting it onto Rule 10b-5 cannot help but accelerate this trend.

Other SEC Disclosure Rules Will Lead to Rule 10b-5 Claims

Neither *Stratte-McClure* nor *Leidos* contains any limiting principle that would prevent all of the sub-items of Item 303 and all of the SEC's specific disclosure rules adopted under other sections of the securities laws from supplying ''duties to disclose'' under Rule 10b-5. If Item 303(a)(3)(ii) creates a duty to disclose that is enforceable by private plaintiffs under Rule 10b-5, that duty would impact the entire MD&A, and not just the disclosures about trends and uncertainties affecting net sales or revenues or income from continuing operations. Such a duty could also apply to all the other items in Regulation S-K as well as to other rules and regulations adopted pursuant to the SEC's authority under Sections 13(a) and 15(d), and perhaps even Section 14(a).

To begin with Item 303, Item 303(a)(1) and Item 303(a)(2)(ii) require disclosure about known trends or uncertainties that ''that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way'' and ''known material trends, favorable or unfavorable, in the registrant's capital resources,'' respectively. Other sections of Item 303 require disclosure of additional information necessary to an understanding of the financial statements, including significant events, transactions or economic changes that affected the reported results. Item 303(a) requires disclosure of ''such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.'' Similarly, the second sentence of Item 303(a)(3)(i) requires a description of ''any other significant components of revenues or expenses that, in the registrant's judgment, should be described in order to understand the registrant's result of operations.'' In contrast to broad and general requirements, the first sentence of Item 303(a)(3)(i) requires registrants to describe ''any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected.''

With the benefit of hindsight, a plaintiff may be able to identify other information that a registrant failed to disclose in accordance with these principles-based disclosure requirements even though the registrant was aware of the possible importance of the information but reached a different judgment at the time the periodic report was filed. The risk of class action liability under Rule 10b-5 for omissions from an MD&A in a Form 10-K or Form 10-Q will mean that companies will have to approach the drafting of MD&A in a more disciplined and formal process so that management judgments about whether to omit any information take into account the Rule 10b-5 risk related to the omission. Whereas today, a company can choose to remain silent and decide not to conduct a public offering that would expose it to the risk of significant liability as a result of a material omission from the registration statement or prospectus for the offering (or any report or portions of a proxy statement filed under the Exchange Act that are incorporated by reference into the registration statement and prospectus) at a time when it is unable to make difficult judgments about required disclosures, a Supreme Court decision that Item 303 creates a duty to disclose that is actionable under Rule 10b-5 would require a company to consider the class action risks of omissions each time it files its periodic and current reports and proxy statements under the Exchange Act. Any difficult judgments about the extent of required disclosures would likely lead simply to more disclosure, including possibly disclosure that is not material, is confusing or obfuscates material information, rather than an omission of disclosure that would expose the company to the risk of Rule 10b-5 liability.

Besides Item 303, other items in Regulation S-K use the terms trend or uncertainty. For example, Instruction 2 to Item 301, Selected Financial Data, requires the five year financial data disclosure to include ''[D]iscussion of, or reference to, any material uncertainties . . . where such matters might cause the data reflected herein not to be indicative of the registrant's future financial condition or results of operations.'' When the selected financial data includes interim periods, Instruction 4 to Instructions to Item 301 requires the interim periods to be updated ''to reflect a material change in the trends indicated. . . .''

As with the other sub-items of Item 303 that do not refer to trends or uncertainties, a number of other items and sub-items of Regulation S-K could be the basis for a complaint by a private plaintiff in a post-*Leidos* environment. For example, Item 103, Legal Proceedings, requires disclosure of ''any material legal proceedings, other than ordinary routine litigation incidental to the business. . .'' A plaintiff may allege, with the benefit of hindsight, that a legal proceeding should have been disclosed even though management had concluded that it was ''ordinary routine litigation incidental to the business.''

Another example is Item 402, Executive Compensation, which has been the subject of much review and controversy over the years. Compensation Committee decisions concerning the pricing of stock options, known as options backdating, were the subject of much controversy and many restatements of financial statements in the mid-2000s. Query whether certain types of current compensation arrangements could meet the same fate as options backdating and result in private plaintiffs bringing Rule 10b-5 actions in the future.

In addition to current items in Regulation S-K, the SEC could adopt new or amend existing disclosure items that could also result in Rule 10b-5 litigation in a post-*Leidos* environment. If the Court affirms *Leidos*, public companies would continue to face the Division's review staff, which would be expecting MD&As to disclose how management sees the business. As discussed above, the additional disclosure in MD&As may blur management's vision because disclosure about known trends and uncertainties would reasonably be expected to multiply, thus obfuscating what management sees. This would result in MD&As being even less readable and information overload increasing. Public companies would also face increased insurance premiums as well as other increases in costs of compliance and the need to fit more processes and people into already crowded preparation schedules for filing periodic reports on a timely basis. In addition to these known uncertainties as a result of the court affirming *Leidos*, public companies would be expected to face a new and very uncer-

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tain challenge that is different than what they have faced in the past. Affirming *Leidos* could mean that companies would be required to approach the drafting of periodic and current reports filed under the Exchange Act in the same way that they approach the drafting of registration statements and prospectuses. They would have to consider the risk of costly class action litigation resulting from an omission that, viewed in hindsight, was a material omission of information required by an SEC disclosure rule or item.

Conclusion

A decision by the Supreme Court affirming *Leidos* would defeat the SEC's purpose in adopting MD&A as expressed in 37 years of administrative history, would represent an unwarranted expansion of the scope of the Rule 10b-5 private action, and would increase compliance costs while replacing meaningful disclosure aimed at letting managements ''tell their story'' with immaterial, defensive disclosure that would help neither shareholders nor the investing public.