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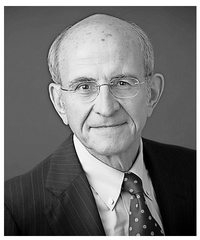
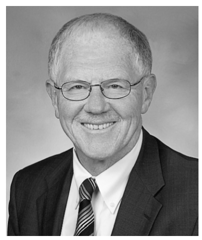
DISCLOSURE

Omnicare and GAAP-Based 'Numerical Opinions'

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

On March 24, 2015, the Supreme Court decided *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund* (''*Omnicare*'').[1] Vacating a ruling by the Sixth Circuit Court of Appeals that liability under Section 11 of the Securities Act of 1933 (''Securities Act'')[2] for a statement of opinion may be premised simply on a showing that the opinion was materially incorrect, the Supreme Court held that an opinion can only be an ''untrue statement of a material fact'' if the speaker does not sincerely hold that opinion, or if the opinion contains an embedded statement of a materially untrue fact. However, the Supreme Court went on to decide that a sincerely-held but incorrect opinion *can* violate Section 11's further prohibition on statements that ''omit[] to state a material fact required to be stated therein or necessary to make the statements therein not misleading'' if (1) the speaker omits material facts about his inquiry into, or knowledge concerning, a statement of opinion, and (2) the omitted facts conflict with what a reasonable investor, reading the statement fairly and in context, would take from the statement itself. *Omnicare* thus clarifies the legacy of *Virginia Bankshares v. Sandberg*,[3] which four courts of appeals[4] had read to stand for the proposition that an

[1] No. 13-435, ___ U.S. ___, 135 S.Ct. 1318 (2015), *vacating Indiana State Dist. Council of Laborers and Hod Carriers Pension and Welfare Fund v. Omnicare, Inc.*, 719 F.3d 498 (6th Cir. 2013).

[2] 15 U.S.C. § 77k.

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[3] 501 U.S. 1083, 1095-96 (1991).

[4] *See Fait v. Regions Fin. Corp.*, 655 F.3d 105 (2d Cir. 2011); *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156 (9th Cir. 2009); *Nolte v. Capital One Fin. Corp.*, 390 F.3d 311 (4th Cir. 2004); *Greenberg v. Crossroads Sys.*, Inc., 364 F.3d 657 (5th Cir. 2004). Another court of appeals decision, *MHC Mut. Conversion Fund, L.P. v. Sandler O'Neill & Partners, L.P.*, 761 F.3d 1109 (10th Cir. 2014), had identified three different approaches to ''opinion'' statements and concluded that it did not need to choose among them because each would have resulted in affirmance of the district court: (1) a common-law theory that opinions are never actionable, *id.* at 1111-13; (2) a strict requirement that the plaintiff plead and prove that the opinion in question was not actually held by the defendant, *id.* at 1113-15; and (3) a third view, which the Tenth Circuit traced to fidu-

opinion statement can give rise to liability only if the speaker subjectively disbelieved the statement.

Much will be written (and much has been written already) about the effect of *Omnicare* on cases that involve textual opinions such as the statements regarding the issuer's compliance with applicable laws that were at issue in *Omnicare* itself. This article considers *Omnicare*'s impact on the Second Circuit's decision in *Fait v. Regions Financial Corporation*,[5] which applied to financial statement numbers the ''subjective disbelief'' requirement that the Second Circuit found in *Virginia Bankshares*, such as goodwill and loan loss reserves, that are matters of judgment under United States Generally Accepted Accounting Principles (''U.S. GAAP'') and thus can be thought of as ''numerical opinions.''[6] Specifically, now that the Supreme Court has gone beyond ''subjective disbelief'' and held that opinions may also be attacked under an omissions analysis, how are the ''numerical opinions'' in financial statements to be analyzed? Given the accelerating trend under U.S. GAAP to require managements to make judgments, prepare estimates, and include opinions (in addition to more traditional statements of fact) in the financial statements, this question is of the utmost importance not only for Section 11 cases, but for all types of securities cases brought by private plaintiffs or by the Securities and Exchange Commission (''SEC'' or ''Commission'') under statutes that use the ubiquitous ''false statement/material omission'' paradigm.[7]

In our view, financial statement numbers based on assumptions, judgments, and estimates analyzed in accordance with U.S. GAAP are opinions under *Omnicare*. They are subject to potential Section 11 liability only to the extent that disclosures about such numbers are not consistent with U.S. GAAP. In addition, we suggest steps that issuers should consider in drafting disclosures for registration statements to be filed under the Securities Act and for periodic reports under the Exchange Act.[8] Among these are: identifying numerical opinions as ''opinions;'' drafting disclosures to, among other things, explain why such ''opinions'' would differ based on different assumptions, judgments, and estimates; and disclosing any important facts that weigh against the assumptions, judgments, or estimates underlying the numerical opinions.

I. *Omnicare*

Omnicare involved a registration statement in which the registrant, a pharmacy services company, made the following representations:

> We believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws.
>
> We believe that our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the healthcare system and the patients that we serve. [9]

The plaintiffs claimed that these statements violated Section 11 because they were belied by Omnicare's receipt of payments from drug manufacturers that violated federal anti-kickback laws, and particularly by a statement by one of Omnicare's attorneys that one particular contract ''carrie[d] a heightened risk of liability' '' under those laws.[10] The district court had held that Omnicare's statements about legal compliance were ''soft information'' as to which the plaintiffs needed to prove the speaker's actual knowledge of falsity.[11] The Sixth Circuit reversed, ruling that Section 11 required the plaintiffs only to show that Omnicare's opinions were ''objectively false'' – in other words, wrong.[12] The Sixth Circuit explicitly rejected the Second Circuit's ''subjective disbelief'' analysis in *Fait*, concluding that the plaintiffs were not obliged to contend that anyone at Omnicare disbelieved the opinions at the time they were expressed.[13] In the Sixth Circuit's view, requiring a Section 11 plaintiff to show ''subjective disbelief'' would effectively impose a scienter requirement and thus would conflict with the Supreme Court's hold-

ciary law, that a speaker may be held liable for an opinion that lacks an objectively reasonable basis, even if that opinion was sincerely held, *id*. at 1115-17.

[5] 655 F.3d at 110-13.

[6] *See* L. Griggs, J. Huber, and C. Mixter, ''The SEC's Renewed Interest in Accounting Cases – A New Beginning or a Victim of *Fait*?,'' 45 BNA Securities Regulation & Law Report 1663 (2013).

[7] *See, e.g.*, Section 12(a)(2) of the Securities Act, 15 U.S.C. § 77l(a)(2); Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a); Section 10(b) of the Securities Exchange Act of 1934 (''Exchange Act''), 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5; Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 13a-1 and 13a-13 thereunder, 17 C.F.R. § 240.13a-1, -13; and Section 14(a) of the Exchange Act, 15 U.S.C. § 78n(a), and Rule 14a-9 thereunder, 17 C.F.R. § 240.14a-9. Certain of these provisions also require the plaintiff to show scienter on the part of the defendant.

[8] Attention to Exchange Act filings is important for two reasons. In Section 11 cases, those filings become relevant because of the integrated disclosure system, which permits certain issuers to incorporate by reference documents filed under the Exchange Act into registration statements filed under the Securities Act. In addition, the other provisions of the securities laws listed in note 7 above – some of which are available to private plaintiffs but all of which can support enforcement action by the SEC – use the same ''false statement/material omission'' concepts as Section 11. In financial fraud and accounting cases, the Commission commonly charges issuers with violations of Section 13(a) of the Exchange Act and the related rules. Although three of those provisions – Section 13(a) itself (requiring Exchange Act registrants to file annual and quarterly reports as required by SEC rules) and Rules 13a-1 and 13a-13 – appear, on their face, only to require that certain information be filed, it is well settled that implicit in the filing obligation is the further requirement that the information be truthful in all material respects. *See* IV L. Loss & J. Seligman, *Securities Regulation* 1854 & n. 2 (3d ed. 1990). The fourth 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.'' Section 13 and the attendant rules are particularly attractive to the SEC because, like Section 11, they do not require scienter on the part of the issuer. *See, e.g.*, *SEC v. McNulty*, 137 F.3d 732, 740-41 (2d Cir. 1998).

[9] 135 S.Ct. at 1323.

[10] *Id.* at 1324.

[11] *Indiana State Dist. Council of Laborers and Hod Carriers Pension and Welfare Fund v. Omnicare, Inc.*, No. 2006-26, 2012 WL 462551 at *4-*5 (W.D. Ky. Feb. 13, 2012).

[12] *Indiana State Dist. Council of Laborers*, 719 F.3d at 505-06.

[13] *Id.* at 506.

   ISSN 0037-0665

ing in *Herman & MacLean v. Huddleston* that scienter need not be shown in Section 11 cases.[14]

The defendants in *Omnicare* obtained a writ of certiorari from the Supreme Court. Relying on *Virginia Bankshares*, the defendants contended that a statement of opinion in a registration statement can only be considered false if the investor can plead and prove that the opinion was not sincerely held by the speaker.[15] The plaintiffs argued that opinion statements convey an implicit affirmation that the opinion is in fact true;[16] alternatively, the plaintiffs contended at oral argument that Omnicare's opinions were materially misleading because they omitted to state material information – namely, the alleged statement by the Omnicare attorney that one particular contract carried a heightened risk of legal exposure.[17] The U.S., through the SEC, filed an amicus curiae brief in *Omnicare* that sided with the plaintiffs by arguing that, to escape liability, the speaker of an opinion must either have a reasonable basis for her opinion, or disclose her lack thereof.[18]

A seven-justice majority of the Supreme Court chose its own path. The seven justices agreed with Omnicare that as a matter of logic and the normal use of language, a statement of opinion has only limited informational content that can be judged true or false: namely, that the speaker indeed holds the opinion in question, and also that any ''embedded facts'' in the opinion (''y'' in a statement like ''I believe 'x' because of 'y' '') are true.[19] However, the majority agreed with the plaintiffs and the SEC that even if the speaker actually held the opinion in question and the opinion expressed no ''embedded facts'' (so that the statement of opinion was not a false statement), the opinion still could be treated as materially misleading if the speaker omitted to state facts known to her that were at odds with the opinion.[20] In an important departure from the positions of the plaintiffs and of the SEC as amicus curiae, the majority opinion did not relate the ''omissions'' to the *speaker's* state of mind but instead to the expectations of the *reader* of the opinion – none other than the objective ''reasonable investor'' made famous in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976).[21] The majority opinion then spent the next several pages attempting to illustrate what the relevant expectations of the ''reasonable investor'' might be.

The majority first addressed Omnicare's argument that ''no reasonable person, in any context, can understand a pure statement of opinion to convey anything more than the speaker's own mindset.''[22] Conceding that ''[t]hat claim has more than a kernel of truth,'' the majority defined that kernel narrowly: ''a statement of opinion is not misleading just because external facts show the opinion to be incorrect. Reasonable investors do not understand such statements as guarantees, and § 11's omissions clause therefore does not treat them that way.''[23] The crux of the majority's ''omissions'' analysis then appears:

> But Omnicare takes its point too far, because a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion – or, otherwise put, about the speaker's basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience. Consider an unadorned statement of opinion about legal compliance: ''We believe our conduct is lawful.'' If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete. In the context of the securities market, an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry—rather than, say, on mere intuition, however sincere. Similarly, if the issuer made the statement in the face of its lawyers' contrary advice, or with knowledge that the Federal Government was taking the opposite view, the investor again has cause to complain: He expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer's possession at the time. Thus, if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability. [24]

The Court then provided two significant qualifiers to the foregoing: first, that not all countervailing facts have equal weight, and that some may be disregarded (using the example of an opinion about legal compliance that is supported by six senior attorneys but not by a seventh, more junior attorney);[25] second (and more significantly for purposes of this article), that

> whether an omission makes an expression of opinion misleading always depends on context. Registration statements as a class are formal documents, filed with the SEC as a legal prerequisite for selling securities to the public. Investors do not, and are right not to, expect opinions contained in those statements to reflect baseless, off-the-cuff judgments, of the kind

[14] *Id.* at 505-07, citing 459 U.S. 375, 382 (1983).

[15] 135 S.Ct. at 1326.

[16] *Id.* at 1325.

[17] *Id.* at 1324, 1333.

[18] Brief for the United States as Amicus Curiae in Support of Vacatur and Remand in *Omnicare*, *available at* 2014 WL 2703331.

[19] 135 S.Ct. at 1325-27.

[20] *Id.* at 1328-29.

[21] *Id.* at 1327-28. Although the majority's focus on the expectations of the reasonable investor is helpful in one way – namely, by distancing the ''omissions'' inquiry from the speaker and thus preventing the confusion with the speaker's scienter that tripped up the Sixth Circuit in its *Omnicare* ruling – it introduces other problems, as Justice Scalia pointed out in his concurring opinion, *see id.* at 1335-37 (Scalia, J., concurring). Justice Scalia suggests that a reasonable investor cannot possibly know how much of an inquiry is needed to support an opinion of the type that issuers frequently are required to offer. He worries that the majority's omissions standard will enable plaintiffs to ''charge that even though the belief rested upon an investigation the corporation thought to be adequate, the investigation was not 'objectively adequate' '' because the belief turned out to be incorrect. *Id.* at 1336-37. With respect to the ''numerical opinions'' that are the subject of this article, we believe that an issuer's compliance with U.S. GAAP, including by providing the disclosures called for by the applicable U.S. GAAP, should protect it from Justice Scalia's concern. See Sections II and III below.

[22] *Id.* at 1328.

[23] *Id.*

[24] *Id.* at 1328-29 (footnotes omitted).

[25] *Id.* at 1329.

that an individual might communicate in daily life. At the same time, an investor reads each statement within such a document, whether of fact or of opinion, in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information. And the investor takes into account the customs and practices of the relevant industry. So an omission that renders misleading a statement of opinion when viewed in a vacuum may not do so once that statement is considered, as is appropriate, in a broader frame. The reasonable investor understands a statement of opinion in its full context, and § 11 creates liability only for the omission of material facts that cannot be squared with such a fair reading. [26]

The Court also attempted to provide some solace to issuers by addressing the types of allegations that a plaintiff would need to make in order to state an omissions-based claim against an opinion in a registration statement. The majority repeated that it will be insufficient for the plaintiff simply to claim that the opinion was wrong, and added that it also will be insufficient for the plaintiff merely to allege that the issuer failed to reveal the basis for its opinion.[27] Instead, the Court stated, ''[t]he investor must identify particular (and material) facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context.''[28]

II. Does *Omnicare* Recognize ''Numerical Opinions'' under GAAP?

Omnicare involved two clearly-labeled textual opinions about legal compliance that both began with the words ''We believe.'' What does the Supreme Court's holding mean for the ''numerical opinions'' mandated by U.S. GAAP, such as values for goodwill and loan loss reserves, which *Fait* and its progeny protected under a ''subjective falsity'' standard? To the casual reader, goodwill, loan loss reserves, and similarly judgmental numbers might look no different from the financial statement numbers that represent cash on hand or the number of common shares outstanding, both of which are objectively verifiable and are not matters of judgment under U.S. GAAP.[29] Thus, if the mere superficial appearance of ''numerical opinions'' were the standard, issuers would face absolute Section 11 liability under *Omnicare* if those numbers turned out to be materially wrong. If, on the other hand, the courts were to treat numbers like the amounts of goodwill and loan loss reserves as judgmental in nature, consistent with U.S. GAAP, then (so long as the issuer did not subjectively disbelieve them) those numbers could not be false statements. They could be attacked as materially misleading only if the plaintiff could plead (and eventually prove) that the speaker omitted facts of the type discussed in Section I above, which the Supreme Court majority described as ''no small task for an investor.''[30]

We submit that ''numerical opinions'' under U.S. GAAP are, indeed, opinions under *Omnicare*. As noted above, the *Omnicare* majority made it clear that ''the full context'' matters in disclosure cases. For registration statements of the type at issue in *Omnicare*, and indeed for any financial statement filed by a domestic issuer, the relevant context begins with the SEC's rules, notably Regulation S-X. The touchstone for financial statement numbers filed under Regulation S-X is U.S. GAAP. Rule 4-01(a)(1) of Regulation S-X states that ''[f]inancial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.''[31] At the simplest level, U.S. GAAP is the language applicable to the preparation of financial statements, including the numerical opinions reflected in those statements as well as the narrative disclosures within those financial statements. It would be quite illogical to require issuers to use that language, but then to make no assumptions about whether the reader of the financial statements – the reasonable investor – has any understanding of that language. As we will see below, the caselaw and logic point in the same direction.

Although, under some very old law in the Second Circuit, U.S. GAAP ''neither establishes nor shields guilt in a securities fraud case,''[32] the Second Circuit has also observed that the purpose of U.S. GAAP is ''to increase investor confidence by ensuring transparency and accuracy in financial reporting.''[33] In the words of then-Circuit Judge Alito writing for the Third Circuit, ''[d]eviations from accounting standards are important insofar as reasonable investors expect those standards to be followed. Given that the market expects that a certain set of accounting standards will be followed, we imagine that a demonstration of explicit compliance with these standards will at least generally negate the possibility that reasonable investors were misled.''[34]

[26] *Id.* at 1330.
[27] *Id.* at 1332.
[28] *Id.*
[29] The only discussion of financial statement numbers in *Omnicare* appears in Justice Scalia's concurrence, which used traditional, ''hard'' balance sheet numbers like cash and outstanding shares to illustrate situations in which the investing public would be entitled to assume a basis for the numbers reported even if those numbers were prefaced with the words ''we believe that.'' *Id.* at 1335. Justice Scalia's assertion that a registrant is presumed to be an ''expert'' for all matters *required* to be contained in a registration statement, *id.*, unfortunately fails to recognize the reality that, as set forth below, registrants must use U.S. GAAP, and U.S. GAAP requires registrants to express opinions.

[30] *Id.* at 1332.
[31] 17 C.F.R. § 210.4-01(a)(1). At least one court of appeals has concluded that an investor, unless informed otherwise, is justified in understanding that U.S. GAAP underlies all financial information promulgated by a registrant. *Romine v. Acxiom Corp.*, 296 F.3d 701, 705 (8th Cir. 2002) (citing Rule 4-01(a)(1) and stating that ''[t]hat means investors can reasonably expect that financial information a company voluntarily includes in a prospectus, including financial forecasts or unaudited recent financial results, was prepared in accordance with GAAP'').
[32] *United States v. Rigas*, 490 F.3d 208, 220 (2d Cir. 2007, citing *United States v. Simon*, 425 F.2d 796, 805-06 (2d Cir. 1969) (Friendly, J.).
[33] *Gould v. Winstar Comms., Inc.*, 692 F.3d 148, 153 (2d Cir. 2012), quoting *In re Global Crossing Ltd. Sec. Litig.*, 322 F. Supp.2d 319, 339 (S.D.N.Y. 2004); *see also SEC v. KPMG LLP*, 412 F. Supp.2d 349, 355 (S.D.N.Y. 2006).
[34] *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1422 n.11 (3d Cir. 1997).

Faced with the "full context" of financial statements, as *Omnicare* requires, the reasonable investor must be viewed as understanding that U.S. GAAP requires some numbers in those financial statements, as well as the related disclosures included in the financial statements, to be based on management's opinions. Achieving that level of understanding certainly is no less natural than knowing the customs and practices of the relevant industry, which *Omnicare* presumes the investor will take into account.[35] Indeed, in many, if not most, cases, an issuer's financial statements will explicitly inform the reader that the reported numbers are infused with management's judgments – in other words, opinions.[36]

The overall scheme of liability under current securities law also requires that the reasonable investor look at financial statements and other disclosures through the eyes of market professionals, who will have an appreciation of U.S. GAAP.[37] Recall that *Basic, Inc. v. Levinson*[38] had three major holdings. First, the Supreme Court adopted for Section 10(b) and Rule 10b-5 cases the objective, "reasonable investor" standard for materiality that was originally developed by *TSC Industries*,,[39] a Section 14(a) case: "to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.' "[40] Second (and least relevant here), the Court ruled that a reasonable investor could regard even preliminary merger discussions as significantly altering that mix.[41] Third, the Court adopted the "fraud on the market" presumption for purposes of showing reliance in Rule 10b-5 class actions: "An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action."[42] Discussing the elements of fraud on the market, the Supreme Court noted that the concept of the "reasonable investor" bridges the materiality and the reliance inquiries:

> The Court of Appeals held that in order to invoke the presumption, a plaintiff must allege and prove: (1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value to the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed. See 786 F.2d at 750.
>
> Given today's decision regarding the definition of materiality as to preliminary merger discussions, elements (2) and (4) may collapse into one. [43]

Certainly it makes scant sense to assume the contrary – namely, that one concept of materiality would underlie liability for a misstatement, but that another concept would come into play to prove reliance on that same misstatement.

Although controversial both in its day and down through the present, the "fraud on the market" presumption was reaffirmed by the Supreme Court last year in *Halliburton Co. v. Erica P. John Fund, Inc*., which described it as based "on the fairly modest premise that 'market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.' "[44] Indeed, in the SEC's view, the role of the market professional is critical:

> When information about a company is released publicly, market professionals assess that information to determine whether and how it should influence their trading decisions. . . . Thus, even when a stock purchaser is unaware of a particular public statement that is relevant to the stock's value, that statement may appropriately be viewed as a legal cause of the market price the buyer pays to acquire the stock. [45]

The Supreme Court has affirmed that materiality is both its own element in a securities fraud action and

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[35] 135 S. Ct. at 1330.

[36] For example, had *Omnicare* itself involved numerical opinions rather than textual opinions, a reader of the December 15, 2005 prospectus at issue would have had to take into account the fact that the prospectus incorporated by reference Omnicare's Form 10-K filing for the year ended December 31, 2004, which stated as follows at pages 80-81:

> Use of Estimates in the Preparation of Financial Statements
>
> The preparation of the Company's financial statements in accordance with U.S. GAAP requires management to make estimates, assumptions and judgments that affect the reported amounts of assets, liabilities and stockholders' equity at the date of the financial statements, the reported amounts of revenues and expenses during the reporting periods, and amounts reported in the accompanying notes. Significant estimates underlying the accompanying consolidated financial statements include the allowance for doubtful accounts; the net carrying value of inventories; the goodwill impairment assessment; accruals pursuant to the Company's restructuring initiatives; employee benefit plan assumptions and reserves; current and deferred income tax assets, liabilities and provisions; and various other operating allowances and accruals (including employee health, property and casualty insurance accruals). Actual results could differ from those estimates depending upon the resolution of certain risks and uncertainties.

[37] *See United States v. Ebbers*, 458 F.3d 110, 125 (2d Cir. 2006) ("[g]ood faith compliance with GAAP will permit professionals who study the firm and understand GAAP to accurately assess the financial condition of the company. This can be the case even when the question of whether a particular accounting practice complies with GAAP may be subject to reasonable differences of opinion.").

[38] 485 U.S. 224 (1988).

[39] 426 U.S. 438 (1976).

[40] 485 U.S. at 231-32, quoting *TSC Industries*, 426 U.S. at 449.

[41] 485 U.S. at 232-42.

[42] *Id*. at 247.

[43] *Id*. at 248 (emphasis added). *See also No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 930, 947-48 (9th Cir. 2003) (discussing interplay of materiality and reliance).

[44] __ U.S. __, 134 S.Ct. 2398, 2410 (2014).

[45] Brief for the United States as Amicus Curiae Supporting Respondent in *Halliburton Co. v. Erica P. John Fund, Inc.*, 2014 WL 466853 at 8 (citation omitted). Interestingly, the SEC's amicus brief in *Halliburton* arrived at a similar concept of "surrogacy" by a different, common-law route:

> Indirect reliance is not limited to the cases identified in *Basic*. See 485 U.S. at 243. An individual may purchase stock based on the recommendation of his broker or a

"an essential predicate of the fraud-on-the-market theory"[46] – just one that the plaintiff need not prove before trial.[47] And if materiality is present in the fraud-on-the-market theory, which rests on the information-processing skills of market professionals, then the technical skills of those market professionals – which, as noted above, include the ability to understand, and correctly interpret, U.S. GAAP – must be an attribute of the "reasonable investor" for purposes of determining liability as well.

Thus, both the contextual analysis mandated by *Omnicare* and a coherent view of liability under the federal securities laws presume that the reasonable investor will regard the financial statement numbers that U.S. GAAP commits to management's judgment as opinions, just as *Fait* did. But unlike *Fait*, *Omnicare* requires a court not only to evaluate management's subjective belief in the reported numbers, but also to weigh whether, even if subjectively believed, the "numerical opinions" in the financial statements omit facts necessary to make them not misleading. The section that follows undertakes that analysis.

III. Can an Issuer Be Liable for Omissions from a Subjectively Believed "Numerical Opinion"?

Even if a "numerical opinion" was subjectively believed and thus is not a false statement, *Omnicare* makes it clear that the opinion must be analyzed for material omissions. What will that analysis look like? Because *Omnicare* involved voluntary, textual statements about the issuer's compliance with applicable laws, *Omnicare* on remand is not likely to be the vehicle by which the courts provide guidance on how to conduct that analysis, even if the *Omnicare* plaintiffs are permitted to replead one or more facts that were missing from Omnicare's registration statement.[48] Since definitive judicial guidance may not come soon, it is worth sketching out that analysis.

We know that, to satisfy the majority's Section 11 framework, a plaintiff cannot simply allege that the number turned out to be wrong [49]or "that the issuer failed to reveal its basis [for the opinion]."[50] Nor can a plaintiff simply state that the numerical opinion was not accompanied with statements "necessary to make the statements therein not misleading,"[51] or make a "conclusory allegation" that the issuer lacked "reasonable grounds for the belief' " that the numerical opinion was correct.[52]

Pleading that a numerical opinion violated the second clause of Section 11, which is expected to be "no small task for an investor,"[53] requires consideration of a reasonable person's expectations and all of the disclosure in the registration statement.[54] A plaintiff must specify the fact or facts that result in the opinion being misleading to "a reasonable person reading the statement fairly and in context."[55] The majority explains that the reasonable person standard requires consideration of what a reasonable person would "naturally understand a statement to convey beyond its literal meaning,"[56] which, "for expressions of opinion . . . means considering the foundation she would expect an issuer to have before making the statement."[57]

The "foundation" for purposes of the evaluation of numerical opinions should once again be U.S. GAAP. As noted in Section II above, a reasonable investor must be viewed as understanding that U.S. GAAP requires an issuer to make judgments about the accounting principles it uses to prepare the financial statements and how it implements those principles. U.S. GAAP frequently also prescribes how the issuer should go about making those judgments. These processes are challenging, as we illustrate below with respect to three accounting concepts: the determination of fair value, the evaluation of whether goodwill is impaired, and the determination whether a particular contingency requires the recognition of a loss.[58]

To an increasing extent, an issuer must recognize an asset at its fair value. U.S. GAAP specifies that the valuation technique selected should be "appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs."[59] U.S. GAAP thus assumes that an issuer's management will apply the relevant guidance in the exercise of its judgment. If the issuer determines to reflect the asset on its balance sheet at fair value but the fair value cannot be determined based on observ-

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stock-tip newsletter. Under petitioners' view, if the broker who made the recommendation was misled by the company's misrepresentations, but the investor who bought the stock was unaware of those specific statements, the investor would be left without a remedy, even though he relied on the statements through the broker. Yet the common law has long recognized such concepts of indirect reliance. See 3 Restatement (Second) of Torts § § 533, 534, at 72, 76.

Id. at 13 n.2.

[46] *Amgen v. Connecticut Ret. Plans and Trust Funds*, 133 S.Ct. 1184, 1195 (2013).

[47] *Id.*

[48] A slightly more promising vehicle is *Freidus v. ING Groep*, which the Supreme Court vacated and remanded to the Second Circuit for further consideration in light of *Omnicare*. *See* 2015 WL 140085 (U.S. March 30, 2015). Even *Freidus* is somewhat unlikely to present the Second Circuit with an opportunity to consider "numerical opinions" because it involved a textual statement by the issuer that "it considered its assets to be of 'relatively high quality,' " which the Second Circuit ruled to be covered by the "subjective disbelief" standard articulated in *Fait*. *Freidus v. ING Groep, N.V.*, 543 F. App'x 93, 95 (2d Cir. Nov. 22, 2013). Although asset quality is conceptually closer to U.S. GAAP-mandated judgments than is Omnicare's compliance with applicable laws, the Second Circuit could resolve *Freidus* without considering the numerical opinions that the SEC's rules and forms require issuers to include in financial statements, *see* Securities Act, Schedule A, pars. 25-26, 15 U.S.C. § 80a-29; 17 C.F.R. Part 230 – General Rules and Regulations, Securities Act of 1933.

[49] 135 S.Ct. at 1332. The first clause of Section 11 "does not allow investors to second-guess inherently subjective and uncertain assessments." *Id.* at 1327.

[50] *Id.*

[51] Section 11(a) of the Securities Act.

[52] *See* 135 S.Ct. at 1333.

[53] *Id.* at 1332.

[54] *Id.* at 1330.

[55] *Id.* at 1332.

[56] *Id.*

[57] *Id.*

[58] For a non-exclusive list of other judgments that are required by U.S. GAAP, *see* L. Griggs, J. Huber, and C. Mixter, *supra* note 6, at 1668-71.

[59] Financial Accounting Standards Board, Codification of Accounting Standards ("ASC") 820-10-35-24.

able market transactions or market information, the issuer will need to estimate the fair value of the asset using valuation techniques. The sufficiency of the ''data'' that an issuer uses to estimate fair value may vary. For example, during the Great Recession, given the illiquidity of many financial instruments, issuers could not obtain truly ''sufficient data'' and had to estimate ''fair value'' using whatever information they had. Even today, the ultimate fair value that many issuers report is an estimate based on the valuation technique selected, and is by no means a guaranteed value. This numerical opinion is one that can easily be wrong, notwithstanding the best intentions of management.

Another asset that involves highly complex judgments is goodwill. While the initial amount of goodwill is based on the purchase price that an issuer pays in a business combination, going forward an issuer must annually determine whether the fair value of that goodwill is lower than the recorded amount, which would require the issuer to recognize an impairment charge. An issuer may estimate the value of goodwill before applying the even more rigorous two-step impairment test by taking into account all relevant events and circumstances, including assessments of increases in costs, industry and market considerations and:

a. Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets

b. Industry and market considerations, such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics ([considered] in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development [60]

Among other things, the two-step impairment test requires an issuer to estimate the price that it would receive if it sold the business unit with which the goodwill is associated ''in an orderly transaction between market participants at the measurement date.''[61] Since the issuer is not then selling the business unit, this is a highly judgmental exercise that may need to take into account synergies and other benefits that an acquiring entity would obtain and a valuation technique based on multiples of earnings or revenue or a similar performance measure.[62] Once again, it is the issuer's responsibility to determine the appropriate approach under the accounting guidance and make judgments on how to apply U.S. GAAP.

Lawyers are quite familiar with issuers' challenges in determining the accounting for loss contingencies. Loss contingencies include losses stemming from injury or damage caused by products sold; risk of loss or damage of property by fire, explosion, or other hazards; actual or possible claims and assessments; the threat of expropriation of assets; and pending or threatened litigation.[63] With respect to litigation, for example, the assessment as to whether a loss should be recognized is based on the probability of an ultimate loss and, if a loss is determined to be probable, whether that loss can be reasonably estimated. Generally those assessments are extremely difficult. The mere fact that litigation results in an adverse verdict does not mean that the company's assessment that the loss was not probable was inconsistent with U.S. GAAP.

Not only does U.S. GAAP provide guidance as to how accounting judgments should be made, but it also requires an issuer to provide disclosures about its significant accounting policies and its implementation of those policies. In this regard, ASC 235-10-50-3 requires an issuer to include a general description of the accounting policies it uses to prepare the financial statements. It states as follows:

> Disclosure of accounting policies shall identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure shall encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it shall encompass those accounting principles and methods that involve any of the following:
>
> a. A selection from existing acceptable alternatives
>
> b. Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry
>
> c. Unusual or innovative applications of GAAP.

U.S. GAAP also identifies specific disclosures that may be required about certain accounting judgments. In the area of loss contingencies, for example, U.S. GAAP provides guidance for the types of disclosure that may be appropriate. It requires certain disclosures about loss contingencies based on the materiality of the contingency, including the nature of the loss contingency and an estimate of the amount of the possible loss or range of loss (or a statement that such an estimate cannot be made when a loss from material litigation is neither probable nor remote or the amount of a probable loss is not reasonably estimable or it is reasonably possible that the loss may be higher than the amount that an issuer accrued).[64] An issuer must decide for itself, however, whether to disclose the amount that it has accrued for a loss contingency because ASC 450-20-50-1 states that disclosure of the amount accrued ''may be necessary for the financial statements not to be misleading.''

An issuer's judgments about which accounting principle to implement, the specific decisions it makes in applying those principles, and the appropriate disclosures about those judgments are opinions. However, they are opinions that are generally reached based on guidance provided by U.S. GAAP. Accordingly, although it is unlikely, as a practical matter, that a plaintiff would be able to ''identify particular (and material) facts going to the basis for the issuer's opinion''[65] that

[60] ASC 350-20-35-3C.
[61] ASC 350-20-35-22.
[62] ASC 350-20-35-23 and 24.
[63] ASC 450-20-05-10.
[64] ASC 450-20-50-3 and 4.
[65] *See* 135 S.Ct. at 1332.

the issuer did not disclose that it should have disclosed, a plaintiff who can do so may have stated an omission claim. Additionally, if the issuer did not follow the accounting principles or methods that it described in its footnotes, or otherwise made inaccurate statements about the accounting principles it followed and implemented, those facts could give rise to liability under the first clause of Section 11 because they are ''embedded facts'' that are either true or false, as the Supreme Court noted in *Omnicare*.[66]

IV. How Should an Issuer Address *Omnicare* in Future Financial Statements?

Despite our views that (1) numerical opinions in financial statements are not false statements as long as the speaker subjectively believes them, and (2) those opinions should also be protected under the *Omnicare* omissions analysis as long as the disclosures cannot be shown to be contrary to U.S. GAAP or include inaccurate facts, we believe that *Omnicare* suggests various steps that issuers should consider taking to enhance their disclosures. Such enhanced disclosures may help avoid protracted litigation, and may increase the likelihood of early dismissal. These steps are the following:

1. Identify the Numerical Opinions that are the Most Susceptible to Change - Identify the numbers in the financial statements that are the most susceptible to change as a result of the use of different assumptions, judgments, or estimates or that could have the most material effect on the issuer's financial statements if they did change. These numbers may be the ones that the issuer considers for disclosure in its Management's Discussion and Analysis (''MD&A'') as resulting from critical accounting estimates.[67] Critical accounting estimates are those ''accounting estimates or assumptions where:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- the impact of the estimates and assumptions on financial condition or operating performance is material.'' [68]

These numbers might also be susceptible to change because of other uncertainties known to management. The identification of those numerical opinions that are most susceptible to change or that could have the most material effect on the issuer's financial statements if they did change should tailor an issuer's disclosures to *Omnicare*.[69]

2. Use the Term ''Opinion'' to Discuss Numerical Opinions – To help investors understand which numbers are the products of assumptions, judgments, and estimates, we suggest that issuers take up the Supreme Court's invitation[70] and identify those numbers as opinions when discussing them. The ''full context'' approach in *Omnicare* suggests that an issuer need not identify numerical opinions as opinions in both the footnotes to the financial statements as well as in the MD&A, but such consistency may facilitate investor understanding. Financial statement disclosure or MD&A discussion about the fair value of an asset, for example, could include the following explanation:

> [''We believe'' or ''we are of the opinion that'' or ''our position is''] that we have properly reflected the fair value of the [the identified asset] on our balance sheet but that fair value is based on specific assumptions, judgments, and estimates that are highly uncertain. If we had determined the fair value based on different, but equally acceptable, assumptions, judgments, or estimates, the fair value would have been different, possibly even materially different.

An issuer might also consider disclosure such as the following, appropriately tailored for the issuer's specific numerical opinions that are most susceptible to change or that could have the most material effect on the issuer's financial statements if they did change:

> *Numerical Opinions in Our Financial Statements*: Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the U.S. (U.S. GAAP), which require management to make assumptions, judgments, and estimates that affect the reported amounts of assets, liabilities, stockholders' equity, revenues, and expenses as well as disclosure about these amounts and commitments and contingencies. In some cases, we do not need to exercise significant management judgment in recognizing an amount. In [many/most/other] cases, we must make assumptions, judgments, and estimates about matters that are inherently and highly uncertain. If our future actual results differ materially from these assumptions, judgments or estimates, our reported financial position or operating results could be materially affected. Examples of our numerical opinions that are particularly susceptible to change because of the uncertainties inherent in the assumptions, judgments, and estimates required

[66] *See id.* at 1327. Note, however, that facts sufficient to plead a materially false or misleading statement for purposes of Section 11 liability may not be enough to permit a private plaintiff (or the SEC) to state a claim under statutes, such as Sections 10(b) of the Exchange Act or Section 17(a)(1) of the Securities Act, that require a showing of scienter or, in the case of Sections 17(a)(2) and (3) of the Securities Act, negligence.

[67] In 2001, the SEC suggested that issuers take various steps to reduce the likelihood that investors lose confidence in the quality of an issuer's disclosure as a result of the absence of disclosures ''about the susceptibility of reported amounts to change.'' ''Action: Cautionary Advice Regarding Disclosure About Critical Accounting Policies'' (Dec. 12, 2001), *available at* https://www.sec.gov/rules/other/33-8040.htm [hereinafter as ''Cautionary Advice''].

[68] Section V, ''Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations'' (Dec. 29, 2003), *available at* https://www.sec.gov/rules/interp/33-8350.htm [hereinafter ''MD&A Interpretation''].

[69] We believe that contemporaneous documentation that specific numerical opinions are not material enough to require discussion in the MD&A may protect an issuer in the event that the issuer's opinion on materiality is the subject of future litigation.

[70] *See* 135 S.Ct. at 1325 (''Most important, a statement of fact ('the coffee is hot') expresses certainty about a thing, whereas a statement of opinion ('I think the coffee is hot') does not''), 1328 (''A reasonable person understands, and takes into account, the difference we have discussed above between a statement of fact and one of opinion. She recognizes the import of words like 'I think' or 'I believe,' and grasps that they convey some lack of certainty as to the statement's content.'' [citation omitted]) .

   ISSN 0037-0665

> to prepare those numerical opinions or that could materially affect the issuer's financial statements if they did change [are/include] [the recognition of revenue because of the need to estimate incentives provided to purchasers, the recognition of doubtful accounts, the need to write down inventory, the need to impair goodwill, the determination of the fair value of our investment securities, the loss contingencies related to litigation or claims made against us, etc.]

3. Enhance Disclosures About the Critical Accounting Estimates – *Omnicare* suggests that issuers should take a look at their disclosures about critical accounting estimates to be sure that these disclosures, as the SEC suggests in its interpretation of the MD&A requirements, address the ''material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements.''[71] Many issuers use substantially the same, if not the same, language to describe critical accounting estimates in the Critical Accounting Estimates section of the MD&A as they use in their notes to the financial statements. This approach may not provide the additional level of protection under the second clause of Section 11 that would be provided by an analysis of the uncertainties underlying those critical accounting estimates. In this regard, the SEC explained as follows:

> Such disclosure should supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements. The disclosure should provide greater insight into the quality and variability of information regarding financial condition and operating performance. While accounting policy notes in the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should present a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time.

> A company should address specifically why its accounting estimates or assumptions bear the risk of change. The reason may be that there is an uncertainty attached to the estimate or assumption, or it just may be difficult to measure or value. Equally important, companies should address the questions that arise once the critical accounting estimate or assumption has been identified, by analyzing, to the extent material, such factors as how they arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future. Since critical accounting estimates and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors. [72]

Appropriate disclosure about a critical accounting estimate might well include important facts that weigh against the assumptions, judgments, or estimates underlying the numerical opinion.

4. Enhance MD&A Disclosures about Trends or Uncertainties Related to Numerical Opinions – Issuers should also consider the need to enhance their MD&A disclosures to discuss known trends or uncertainties that may affect their numerical opinions. Instruction 3 to Item 303(a) of Regulation S-K requires an issuer to consider the need for disclosure about material trends or uncertainties known to management when those known trends or uncertainties suggest that historical results may not be representative of future results. It provides as follows:

> The discussion and analysis 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. This would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past, and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations. [73]

An SEC interpretive release explains when such known trends or uncertainties should be disclosed. It provides that management should evaluate such known trends or uncertainties as follows:

> (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. [74]

Therefore, if a material change in a numerical opinion is reasonably likely in the future because of a known trend or uncertainty, the issuer should discuss this trend or uncertainty and its impact on the numerical opinion in its MD&A.

An issuer should also consider whether its discussion about changes in the results of operations, financial po-

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[71] *See* MD&A Interpretation, *supra* note 68, at n. 58.

[72] *Id.*, Section V. The SEC gives an example of the possible additional disclosure about a critical accounting estimate in Section V. It states as follows: ''For example, if reasonably likely changes in the long-term rate of return used in accounting for a company's pension plan would have a material effect on the financial condition or operating performance of the company, the impact that could result given the range of reasonably likely outcomes should be disclosed and, because of the nature of estimates of long-term rates of return, quantified.'' *Id.*

[73] Instruction 3 to Item 303 of Regulation S-K, *available at* http://www.ecfr.gov/cgi-bin/text-idx?SID=8e0ed509ccc65e983f9eca72ceb26753&node=17:3.0.1.1.11&rgn=div5#se17.3.229_1303.

[74] Section III.B., ''SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures'' (May 18, 1989), *available at* http://www.sec.gov/rules/interp/33-6835.htm.

sition, or liquidity should address changes that related to uncertainties that affected its numerical opinions in the prior period. Appropriate cross-references to details in the financial statements would avoid repetition that, in some cases, might adversely affect investor understanding and, in a worst case, obfuscate important information. Another way to provide investors with more accessible disclosure about numerical opinions might be for an issuer to provide a glossary or index to its financial statement notes and its MD&A disclosure about such opinions.

5. Make Sure that the Audit Committee Concurs with the Proposed Disclosure Prior to Filing[75] – The audit committee plays an important role in overseeing the preparation of financial statements and the MD&A. Given the importance of enhancing an issuer's protection from liability for numerical opinions under the second clause of Section 11, we suggest that issuers discuss the proposed disclosure about numerical opinions with the audit committee. The audit committee's participation in meetings of the board of directors and with the auditors related to the numerical opinions reflected in the financial statements will enable the committee to assist the issuer in developing appropriate disclosure.

We believe that these steps are consistent not only with the Supreme Court's focus in *Omnicare* on the ''full context'' of disclosure, but also with the SEC's current disclosure effectiveness project, through which the SEC intends to reduce costs and burdens on issuers, eliminate duplicative disclosures, and ensure the adequacy of required disclosures.[76]

Conclusion

Omnicare confirms the teaching of *Virginia Bankshares* that honestly-held opinions are not false statements under the federal securities laws. The opinions that are entitled to that latitude should continue to include the ''numerical opinions'' recognized by *Fait* and its progeny. *Omnicare* expands the analysis required for ''numerical opinions'' to include judicial review of whether a ''numerical opinion'' suffers from material omissions. However, circumstances in which a plaintiff can successfully allege such material omissions should be rare, particularly if the issuer has complied with U.S. GAAP. That said, public companies would do well to review their disclosures to confirm the ''opinion'' nature of their U.S. GAAP-based judgments, and to disclose important facts that weigh against the assumptions, judgments, or estimates underlying the numerical opinions.

[75] *See* Cautionary Advice, *supra* note 67.

[76] Keith Higgins, Director, Division of Corporation Finance, SEC, *Shaping Company Disclosure: Remarks before the George A. Leet Business Law Conference* (Oct. 3, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543104412.

   ISSN 0037-0665