No. 16-581

IN THE

Supreme Court of the United States

LEIDOS, INC., F/K/A SAIC, INC.,
Petitioner,

v.

INDIANA PUBLIC RETIREMENT SYSTEM, ET AL.,
Respondents.

On Writ of Certiorari
to the United States Court of Appeals
for the Second Circuit

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS AMICI CURIAE SUPPORTING PETITIONER

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INTEREST OF THE *AMICI CURIAE*[1]

The Securities Industry and Financial Markets Association ("SIFMA") is a securities industry trade association representing the interests of hundreds of securities firms, banks, and financial asset managers across the United States. SIFMA's mission is to support a strong financial sector while promoting investor opportunity, capital formation, job creation, economic growth, and the cultivation of public trust and confidence in the financial markets.

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. It directly represents the interests of 300,000 members and indirectly represents more than three million companies and professional organizations of every size, in every economic sector, and from every region of the country. One important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files *amicus curiae* briefs in cases that raise issues of concern to the nation's business community.

Many of *amici*'s members are subject to the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78a *et seq.*, and accordingly, Rule 10b-5, 17 C.F.R. § 240.10b–5. They are also subject to Regulation S-K and, specifically, to Item 303, which calls for manage-

[1] All parties have consented to the filing of this brief. Written consents are on file with the Clerk. No counsel for a party authored any part of this brief, and no such counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici curiae*, their members, or their counsel made a monetary contribution to the brief's preparation or submission.

ment to discuss and analyze certain "trends" and "uncertainties." 17 C.F.R. § 229.303. *Amici*'s members know first-hand the challenges of complying with the nebulous requirements of Item 303 and associated guidance by the Securities and Exchange Commission ("SEC").

For decades, *amici*'s members and other issuers of publicly traded securities have understood that compliance with Item 303 is not actionable under Rule 10b-5, consistent with the view in each circuit to have addressed the question. Only recently did the Second Circuit split from that consensus. Affirming the Second Circuit's approach and exposing publicly traded companies to private lawsuits over compliance with Item 303 would require *amici*'s members to change their approach in fundamental ways.

Item 303 asks a company's management to set forth its own unique perspective, using its own best judgment to discuss pertinent trends and uncertainties. Making the adequacy of disclosure under Item 303 actionable under Rule 10b-5 will replace management's best judgment with juries' hindsight. Even when a company concludes that particular predictions or analysis need not or, indeed, should not be included in the narrative discussion, the threat of liability will compel companies to include material that is both immaterial and unhelpful to investors. That is squarely at odds with the deferential and flexible approach that the SEC intended with Item 303. *Amici* have an interest in preserving the present boundaries of Rule 10b-5 and the careful balance of information released pursuant to Item 303.

SUMMARY OF ARGUMENT

1. Item 303 identifies certain information that the management of a publicly traded company must disclose as part of its "discussion and analysis" of its "financial condition and results of operations." 17 C.F.R. § 229.303. The disclosure requirement includes certain forward-looking information, i.e., "known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact." *Id.* § 229.303(a)(3). But Item 303 draws no clear line between what is required to be disclosed and discussed and what is optional, as commentators have recognized for years.

As a result, the SEC has construed this provision in a manner that gives company management a great deal of flexibility and deference in deciding what information to disclose, fully acknowledging the subjectivity of the analysis and the difficulty of the determinations managers must make. Indeed, the SEC has counseled against disclosing too much forward-looking information, for fear that information overload would make the disclosure less valuable to investors.

Rule 10b-5 liability cannot be based on policing compliance with an unclear standard that company managers were given flexibility to apply. Item 303 is simply ill suited for application by private class-action plaintiffs' counsel.

2. This Court has expressed similar concerns about information overload in the Rule 10b-5 context. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Court warned that a low standard of materiality would encourage a kitchen-sink approach to disclosure, which

would trigger an "avalanche of information" of questionable utility to investors. Immediately after this Court decided *Basic*, the SEC took care to note that, because the disclosure standard under Item 303 was dramatically different from the materiality standard of Rule 10b-5, *Basic* was "inapposite." This recognition served to avoid the influx of information that would result if Item 303 and *Basic*'s materiality test were conflated.

Holding that Item 303 omissions could be subject to Rule 10b-5 liability, as the Second Circuit has now done, would inevitably trigger the "avalanche of information" that both the SEC (with respect to Item 303) and this Court (in the Rule 10b-5 context) have taken pains to prevent. The mere specter of potential liability, however tempered it may be by Rule 10b-5's other elements, will encourage company management to dump as much forward-looking information as it can out of an abundance of caution. Information piled up under threat of litigation, in turn, may prove to be more unreliable than what managers disclose in their own judgment under the cautious, flexible, and discretionary approach currently understood to apply to Item 303.

3. Exposing Item 303 disclosures (and omissions) to Rule 10b-5 liability is all the more problematic because of the hindsight perspective of Rule 10b-5 litigation. Under the Second Circuit's approach, a trier of fact would have to determine the likelihood of an adverse event or trend at the time the decision to disclose was made (both through the lens of management and an objective, reasonable investor), and the likelihood of that event or trend causing adverse consequences, also at the time management

made the decision to disclose (or omit). The trier of fact would be making these probabilistic determinations after the adverse event or trend already has occurred, which incurably taints the trier of fact's analysis with hindsight bias caused by knowledge of the outcome. A trier of fact with such bias is incapable of "stepping into the shoes of management," which in turn, strips away the protective value of the flexibility that the SEC gave to company management to determine which of management's predictive judgments were worthy of disclosure.

ARGUMENT

Petitioner has thoroughly explained (Br. 27-41) why reporting requirements like Item 303 do not create any duty to disclose that could be actionable under Rule 10b-5. This brief focuses on why Item 303, in particular, is an inappropriate basis for enforcement through private civil damages actions. Item 303 is notoriously nebulous and difficult to apply. For Item 303 to be useful for its intended purpose, companies' managers need to be able to use their best judgment in assessing the trends and uncertainties warranting discussion. Allowing private plaintiffs and their counsel to flyspeck those judgments, with the benefit of hindsight, will leave managers facing an ever-present threat of civil liability. The result will be vastly more boilerplate discussion—and a substantially less useful Item 303.

A. Item 303 provides a standard for disclosure that is too malleable and too deferential to impose an actionable duty under Rule 10b-5.

Throughout its history, Item 303 has consistently been difficult to apply. Despite extensive attempts at

guidance by the SEC, it is still difficult for corporate managers to know what *must* be included pursuant to Item 303. And complicating matters further, the SEC affirmatively *discourages* managers from including information that is not required and not helpful. The SEC itself has recognized the interpretive challenges managers face and emphasized that those managers are entitled to deference in carrying out that task. Given that even the SEC itself recognizes how fuzzy the boundary lines of Item 303 have always been, private civil liability under Rule 10b-5 is a singularly inappropriate way of policing footfaults.

1. Item 303 sketches a blurry line between which disclosures are required and which are merely optional.

Before the advent of Item 303, the SEC had considered forward-looking information too untrustworthy for public consumption. Mark S. Croft, *MD&A: The Tightrope of Disclosure*, 45 S.C. L. Rev. 477, 483 (1994) ("Prior to the 1970s, the Commission's approach to MD&A was to discourage predictive statements and to focus primarily on historical information, on the theory that although soft information was inherently unreliable, the public might give it undue credence."). Indeed, not only was such information deemed irrelevant, predictive information was considered potentially misleading and was banned outright from certain securities statements. *See, e.g.*, *Adoption of Amendments to Proxy Rules*, SEC Release No. 5276, 1956 WL 7757, at *4 (Jan. 17, 1956) ("The following are some examples of what . . . may be misleading within the meaning of this rule: . . . [p]redictions as to specific future market values, earnings, or dividends."). Courts, too, shared this

distrust. *See Union Pac. R.R. Co. v. Chi. & N.W. Ry. Co.*, 226 F. Supp. 400, 409-10 (N.D. Ill. 1964) ("prediction of specific earnings" was "extremely speculative" and "possibly misleading," as "such predictions . . . convey[ed] a certitude which inherently they cannot possess"); *see also Rodman v. Grant Found.*, 608 F.2d 64, 72 (2d Cir. 1979) ("Full factual disclosure need not be embellished with speculative financial predictions."); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 421 (6th Cir. 1974) ("[T]he law mandates disclosure of only existing material facts. It does not require an insider to volunteer any economic forecast."). The SEC maintained its skepticism until the early 1970s. *See, e.g.*, *Guidelines for Release of Information by Issuers Whose Securities are in Registration*, SEC Release No. 33-5180, 1971 WL 120474, at *1 (Aug. 20, 1971) ("[A]ny publication of information by a company in registration other than by means of a statutory prospectus should be limited to factual information and should not include such things as predictions, projections, forecasts or opinions with respect to value.").

By 1973, however, the SEC began to change its tune, motivated by market consensus that the "use of projections would assist in the protection of investors and would be in the public interest." *Statement by the Commission on the Disclosure of Projections on Future Economic Performance*, SEC Release No. 34-9984, 1973 WL 149309, at *1 (Feb. 2, 1973). Because the market had been using the information anyway, the SEC moved "gradually" toward a system of regulating such disclosures. *Id.* at *3. This eye for reform corresponded with broader efforts to encourage voluntary disclosures in other contexts, such as in the reporting of earnings summaries. *See Guides for Preparation and*

Filing of Registration Statements, SEC Release No. 4936, 1968 WL 87679, at *9 (Dec. 9, 1968) (summaries of earnings should disclose "[t]he existence of any unusual conditions affecting the propriety of the presentation").

The SEC's efforts to manage forward-looking predictive information culminated in 1980 with the regulatory provision that now appears as Item 303. With the adoption of Item 303, companies were required to report on "liquidity, capital resources, and the results of operations," which collectively is referred to as management's discussion and analysis ("MD&A"). *Amendments to Annual Report Form, Related Forms, Rules, Regulations and Guides*, SEC Release No. AS-279, 1980 WL 20863, at *13 (Sept. 2, 1980). As part of that disclosure, the SEC stated, "there would be an emphasis upon favorable or unfavorable trends and upon the identification of significant events or uncertainties." *Id.* at *14. Despite the broadened disclosure standard, the SEC intended for the rules to "remain[] . . . general in nature," as a "flexible approach would elicit more meaningful disclosure." *Concept Release on Management's Discussion and Analysis of Financial Condition and Operations*, SEC Release No. S7-14-87, 1987 WL 847497, at *3 (Apr. 17, 1987) ("1987 Guidance"). The Commission reasoned that such flexibility was necessary—"because each registrant is unique, no one checklist could be fashioned to cover all registrants comprehensively." *Id.*

At the heart of this new requirement was *management's* own perspective. The SEC "intended to give the investor an 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." *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, SEC Release No. 6835, 1989 WL 1092885, at *3 (May 18, 1989) ("1989 Guidance") (emphasis added).

With respect to the disclosure of forward-looking information, Item 303 distinguishes between two types of information—required and optional. "Required" disclosure consists of "currently known trends, events, and uncertainties that are reasonably expected to have material effects." *Id.* at *4. Examples of "required" disclosures include "[a] reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract." *Id.* "Optional" disclosure, on the other hand, is disclosure of "anticipat[ion] of a future trend or event or anticipat[ion] of a less predictable impact of a known event, trend or uncertainty." *Id.*

The boundary between "required" and "optional" disclosure was blurry at best, and managers found it confusing to apply in practice. The SEC itself seemed to recognize early in Item 303's history that it would be difficult to tell the difference, noting that "[b]oth required disclosure . . . and optional forward-looking information may involve some prediction or projection." 1987 Guidance, 1987 WL 847497, at *4. Not only was Item 303's plain language on prospective disclosures "antithetical" and "incongruous," the guidance on how to comply with Item 303's requirements was equally confusing. Croft, *supra*, at 483. In the early 1990s, for instance, the guidance to Item 303 stated: "Regis-

trants are encouraged, but not required, to supply forward-looking information." 17 C.F.R. § 229.303, cmt. 7 (1993). But the guidance also stated, in the very next sentence, that "presently known data which will impact upon future operating results . . . *may* need to be disclosed." *Id.* The guidance offered only a few examples, not a meaningful test for determining when information would not be "forward looking" but also have an "impact upon future operating results."

Despite several attempts by the SEC to explain when a predictive judgment goes from an optional disclosure to a mandatory one, Item 303's disclosure regime continues to befuddle corporate management. *See* 3 Bromberg & Lowenfels on Securities Fraud § 6:13 (2d ed.) ("[T]he distinction [between required and voluntary disclosures] is not easy for companies deciding what to disclose."). Commentators have consistently remarked that, given the fluidity of predictive information, knowing when to disclose is a difficult task. *See* Croft, *supra*, at 478 ("Under Item 303 . . . the MD & A disclosure requirements are open-ended and exceedingly complex."); Denise Voigt Crawford & Dean Galaro, *A Rule 10b-5 Private Right of Action for MD&A Violations?*, 43 Sec. Reg. L.J. 1, 1 (2015) ("And the test set out by the Commission for assessing MD&A disclosures has been poorly worded and incongruous for twenty-six years."); Lauren M. Mastronardi, Note, *Shining the Light a Little Brighter: Should Item 303 Serve as a Basis for Liability Under Rule 10b-5?*, 85 Fordham L. Rev. 335, 349 (2016) ("Despite . . . guidance from the SEC, the requirements under this section are flexible and complicated, leaving the company with a difficult task."); Suzanne J. Romajas, Note, *The Duty to Disclose Forward-Looking Information: A Look*

at the Future of MD&A, 61 Fordham L. Rev. S245, S286 (1993) ("[T]he distinction that the SEC has drawn between required and optional disclosures is so subtle that corporations and courts alike find Item 303 of Regulation S-K difficult to apply.").

2. Item 303 gives management substantial deference in deciding what to disclose.

Perhaps because of the difficulty in determining what disclosures are required under Item 303, the SEC has made clear that the rules accord deference to corporate management in deciding what to disclose. The SEC correctly recognized that if its disclosure regime were both hard to apply *and* hard on managers who misapplied it, managers would have to protect themselves through prophylactic over-disclosure. To avoid that result, the SEC consciously gave management leeway to make its own judgments. The 1989 Guidance, for instance, reiterated that Item 303 was "intentionally flexible and general," in the spirit of "elicit[ing] more meaningful disclosure and avoid[ing] discussions which a more specific approach would foster." 1989 WL 1092885, at *1.

The SEC has also stressed the subjective nature of determining what must be disclosed. It has, for instance, repeatedly suggested that Item 303's narratives were intended to allow "investors to see the company through the eyes of management," and that "[m]anagement has a unique perspective on its business that only it can present." *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, SEC Release Nos. 33-8350, 34-48960, 68 Fed. Reg. 75,056, 75,056 (Dec. 29, 2003) ("2003 Guidance"); *see also* Crawford & Gala-

ro, *supra*, at 1 ("MD&A disclosures are inherently tricky, straddling the line between protected projections and vulnerable facts. . . . Regulation S-K gives registrants leeway to use their judgment in disclosing pertinent trends and uncertainties.").

As part of an attempt to provide guideposts for disclosure, the SEC directed the management of publicly traded companies to follow a two-part test to determine whether disclosure of forward-looking information is necessary:

> 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.

1989 Guidance, 1989 WL 1092885, at *6. This test incorporates two layers of deference. First, it defers to management's judgment as to whether an event is "reasonably likely to occur" in the first place. Second,

it tasks management with determining, based on objective criteria, whether the consequences of that event are likely to "come to fruition." The SEC has implicitly recognized that the deference is necessary given the "challenge" faced by corporate management "of identifying information that is required to be disclosed or that promotes understanding, while avoiding unnecessary information overload for readers by not disclosing a greater body of information, just because it is available, where disclosure is not required and does not promote understanding." 2003 Guidance, 68 Fed. Reg. at 75,060.

Indeed, the SEC's Item 303 guidance explicitly counsels *against* over-disclosure. It leaves to management the first task of winnowing disclosures—*i.e.*, identifying and evaluating "what information . . . is important to providing investors and others an accurate understanding of the company's current and prospective financial position and operating results." *Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations*, SEC Release No. 8056, 2002 WL 77153, at *2 (Jan. 22, 2002). If disclosed information is "not required and does not promote understanding," management is explicitly instructed to at least "deemphasize" such information—and "if appropriate," to "delete" it altogether. 2003 Guidance, 68 Fed. Reg. at 75,060.

B. This Court has consistently declined to interpret Rule 10b-5 in ways that would produce "an avalanche of trivial information."

"Silence, absent a duty to disclose, is not misleading under Rule 10b-5." *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988). And as petitioner explains (Br. 18-19), duties to disclose under the securities laws are carefully circumscribed. Indeed, this Court has explicitly rejected the view that more required disclosure is always an unmitigated good thing. In explaining the role of Rule 10b-5's materiality requirement, the *Basic* Court explained that the securities laws should not be interpreted in a manner that might flood the market with information of uncertain value. Reiterating the notion that "certain information concerning corporate developments could well be of 'dubious significance,'" the *Basic* Court cautioned that disclosure of "an overabundance of information within [management's] reach" could subject investors to "'an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.'" *Id.* at 231 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976)). It therefore perceived Rule 10b-5's materiality requirement as a "filter" of "essentially useless information that a reasonable investor would not consider significant, even as part of a larger 'mix' of factors to consider in making his investment decision." *Id.* at 234 (citing *TSC Indus.*, 426 U.S. at 448-49)).

These concerns prompted the *Basic* Court to set forth a two-factor test to determine the materiality of a disclosure. Materiality, the Court opined, "will depend at any such time upon a balancing of both the indicated

probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *Id.* at 238 (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)). To determine probability in the merger context, the Court directed parties to consider "indicia of interest in the transaction at the highest corporate levels." *Id.* at 239. Magnitude, on the other hand, depended on the size and cost of the transaction. *See id.* (magnitude in the merger context requires consideration of "the size of the two corporate entities and of the potential premiums over market value").

Shortly after this Court decided *Basic*, the SEC announced that the probability/magnitude test for Rule 10b-5 liability was ill suited to govern disclosure under Item 303. Because Item 303 "mandates disclosure of specified forward-looking information, and specifies its own standard for disclosure—i.e., reasonably likely to have a material effect," the SEC determined that "[t]he probability/magnitude test . . . is inapposite to Item 303 disclosure." 1989 Guidance, 1989 WL 1092885, at *6 n.27.

Commentators expanded on the SEC's cautionary note, positing that the *Basic* framework was simply incompatible with the existing scheme for the disclosure of forward-looking information. They noted that forward-looking information was likely to be the product of an imperfect process because "[d]etermining a discrete probability of some unique kind of business event occurring is an intellectual challenge that few humans are likely to confront consistently or coherently." Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 Wash. U.

L.Q. 753, 775 (1997). Accordingly, subjecting forward-looking statements to Rule 10b-5 (and thus, the *Basic* probability/magnitude test) would "create[] the risk of overdisclosure, diluting the effectiveness of the more important." *Id.*

C. Using Item 303 as a basis for liability under Rule 10b-5 runs contrary to the purpose of both provisions.

Item 303 disclosures do not fit within *Basic*'s probability/magnitude framework. The nature of the task that Item 303 sets for corporate managers is different in kind from any recognized basis for Rule 10b-5 liability. And the incentive structure that comes with Rule 10b-5 liability is fundamentally incompatible with Item 303.

That has long been the prevailing view. In *Oran v. Stafford*, 226 F.3d 275 (2000) (Alito, J.), the Third Circuit explained that, because Item 303's "disclosure obligations extend considerably beyond those required by Rule 10b-5," "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.'" *Id.* at 288 (citation and internal quotation marks omitted). Instead, the court required a *separate* duty to disclose. Fourteen years later, the Ninth Circuit followed suit in *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014), concluding that the capaciousness of Item 303's disclosure rules was evidence that Item 303 did not, by itself, create an actionable duty under Rule 10b-5. *Id.* at 1055-56. The Sixth Circuit, too, has expressed skepticism that Item 303 omissions are somehow actionable under Rule 10b-5. *See, e.g.*, *In re Sofamor Danek Grp.,*

Inc., 123 F.3d 394, 403 (6th Cir. 1997) (rejecting argument that "defendants' disclosure duty under the Rule 10b-5 claim may stem from Item 303").

The Second Circuit, however, recently disagreed. It takes the view that because Item 303's discussion of future trends and uncertainties is mandatory, any omission from the MD&A is a representation from which a reasonable investor would infer that there are no "known trends or uncertainties" that would "'have a material . . . unfavorable impact on . . . revenues or income from continuing operations.'" *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 102 (2d Cir. 2015) (quoting 17 C.F.R. § 229.303(a)(3)(ii)).

That approach is ultimately self-defeating. Item 303 asks management to use its best judgment to address nebulous concepts like "uncertainties" and "trends." The threat of class-action liability if that "uncertainties" discussion is found deficient in hindsight would encourage what the *Basic* Court sought to avoid in the first place: flooding the market with information of questionable value and obscuring the much more valuable opportunity to hear management's undistorted perspective. And it would strip management of the deference and flexibility the SEC sought to give them. Managers need to be able to give shareholders a clear-eyed look ahead, without needing to look anxiously over their shoulders.

1. Turning Item 303's disclosure requirement into an actionable "duty" under Rule 10b-5 will result in disclosure that is both voluminous and unhelpful.

Using Item 303 as the basis for Rule 10b-5 claims raises exactly the same risk of counterproductive over-disclosure that this Court has warned about in other 10b-5 contexts. Thus, the SEC has repeatedly stressed that companies should include information in its MD&A *only* if management deems that it would promote understanding, and that any questionable material should be either deemphasized or deleted. *See* 2003 Guidance, 68 Fed. Reg. at 75,060. The SEC does not want "unnecessary information overload." *Id.* at 75,057.

The *risk* of liability will create pressure for further disclosure of forward-looking information. *Cf.* Troy A. Paredes, *Blinded By the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U. L.Q. 417, 429 (2003) ("risk of liability for failure to disclose," i.e., "fraud," will compel more disclosure). That pressure to disclose may, in turn, affect the usefulness of what is disclosed. "Studies show that when people are held accountable, . . . they try to process more information in more complex ways." *Id.* at 456. The predictable result will be the "overinterpretation" of information by management, with corporate officers focusing "too much on less relevant information while ignoring key (or 'diagnostic') information, and pay[ing] too much attention to conflicting information" in anticipation of scrutiny by investors. *See id.* at 456-57. The predictive disclosures may also be marked by overconfidence—"people overestimate their ability to

evaluate information and predict the future based on available data." *Id.* at 457.

The market may already be inundated. Generally speaking, financial disclosures may have reached the point where they are so lengthy that information of importance to investors is buried in the reporting. Arthur J. Radin, *Have We Created Financial Statement Disclosure Overload?*, 77 The CPA J. 6 (2007) ("There is much significant information to be found in a long financial report. But as an investor looking at the number of pages that are boilerplate, redundant, immaterial, irrelevant, or overly factpacked, I immediately suffer from MEGO—my eyes glaze over.").

Similarly, MD&A disclosures have ballooned in size even without the specter of Rule 10b-5 liability imposed by the Second Circuit. In one study of 25 large, well-known companies, the number of pages devoted to MD&A disclosures increased 300% between 1972 and 1992—the period during which Item 303 took shape. Ernst & Young, *To the Point: Now Is the Time to Address Disclosure Overload*, at 1 (June 21, 2012), *available at* http://www.ey.com/Publication/vwLUAssets/ToThePoint_BB2367_DisclosureOverload_21June2012/$FILE/TothePoint_BB2367_DisclosureOverload_21June2012.pdf. MD&A disclosures went from an average of three pages in 1972 (before Item 303 was promulgated), to seven pages in 1982 (during Item 303's infancy), to 12 pages in 1992, and to *48* pages in 2011. *Id.* at 2. The study predicted that MD&A disclosures would reach an average of *214 pages* by 2032. *Id.*

Investors cannot use information effectively if it is not useful. *See* U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, *Essential Infor-*

mation: Modernizing Our Corporate Disclosure System 13-14 (2017) ("[I]nvestors often voice their disapproval with the current SEC disclosure regime as they encounter needlessly voluminous and complicated SEC filings."), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/U.S.-Chamber-Essential-Information_Materiality-Report-W_FINAL.pdf?x48633. As then-Professor William O. Douglas wrote, "the disclosure of information will not adequately protect investors or result in better decisionmaking if investors are unable to understand and process the information." William O. Douglas, *Protecting the Investor*, 23 Yale L. Rev. 521, 523-34 (1934), *available at* https://www.sec.gov/news/speech/1934/030034douglas.pdf. And information overload—which the Second Circuit's decision threatens to impose—inhibits the ability of investors, even sophisticated ones, to process information effectively. *See* Mary Jo White, Chairman, Secs. & Exch. Comm'n, The Path Forward on Disclosure (Oct. 15, 2013) (describing "information overload" as "a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out information that is most relevant"), *available at* https://www.sec.gov/news/speech/spch101513mjw. The SEC recognized this when it gave corporate management flexibility in what forward-looking information was to be reported. *Cf*. 2003 Guidance, 68 Fed. Reg. at 75,060 (recognizing the "challenge" of providing adequate information pursuant to Item 303, while "avoiding unnecessary information overload").

Even looking at Item 303 disclosures in isolation, the amount of information conveyed by publicly traded

companies may already have ballooned out of control. *See* Ernst & Young, *supra*, at 2. By raising the specter of class-action litigation with every disclosure, the Second Circuit has only encouraged company management to pile it on out of an abundance of caution.

2. Encouraging managers to hedge their discussion with prophylactic disclosures will deprive investors of access to management's perspective.

The unnecessary overdisclosure produced by the threat of liability does more than just make SEC filings longer. In the case of Item 303 in particular, overdisclosure would run contrary to the very purpose of the provision: to present management's perspective in candid narrative form.

As the SEC has said, it "intended to give the investor an 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." 1989 Guidance, 1989 WL 1092885, at *3 (emphasis added). Part of what makes the MD&A useful is that it provides the company's own take on itself, its competitors, and its industry, in a narrative form that is distinct from the quantitative data found in an audited financial statement. *See, e.g.*, 2003 Guidance, 68 Fed. Reg. at 75,060. For instance, the introduction should address the risks posed by uncertainties "with which management *is* concerned primarily," *id.* (emphasis added), a task that becomes more difficult if the threat of liability leaves management feeling compelled to include a boilerplate discussion of every conceivable uncertainty in the business universe. The MD&A can be useful because it sheds light not just on (*e.g.*) a busi-

ness uncertainty, but on management's assessment of it and response to it. The latter will get lost in the stack if the disclosure must address every conceivable risk or uncertainty, for fear of liability if one is omitted. That result benefits neither the market nor individual investors.

3. Adopting the Second Circuit's approach would leave companies exposed to nuisance lawsuits shaped by hindsight.

A decision by this Court expanding the universe of actionable omissions to include Item 303 omissions would significantly increase companies' exposure to hindsight-driven litigation and the attendant litigation costs and settlement pressure.[2] The Second Circuit's approach already has encouraged securities plaintiffs to closely scrutinize Item 303 disclosures and a company's operations in the hopes of finding the lottery ticket of an arguably actionable omission. *See, e.g.*, *Ong v. Chipotle Mexican Grill, Inc.*, No. 16-cv-141, 2017 WL 933108, at *10, *17-18 (S.D.N.Y. Mar. 18, 2017) (plaintiffs alleged that restaurant chain violated the securities laws by failing to discuss the risks of a "transition to in-store produce preparation"). Even if a registrant

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[2] *See, e.g.*, Deborah R. Meshulam, *Significant Securities Litigation Cases of Recent Times and Their Impacts on Clients and Attorneys*, in *New Developments in Securities Litigation* (2015), 2015 WL 2407611, at *12 (predicting that "Item 303" will lead to "increased securities litigation"); *see also* Suzanne J. Romajas, Note, *The Duty to Disclose Forward-Looking Information: A Look to the Future of MD&A*, 61 Fordham L. Rev. S245, S274 (1993) (arguing that Item 303 "does impose an affirmative duty to disclose" and that "[p]laintiff attorneys therefore can be expected to continue basing Rule 10b-5 claims on Item 303 violations").

ultimately prevails in such litigation, there is a significant cost to defending against such second-guessing.

And litigants cannot count on prevailing even in weak cases. Item 303 asks management to assess risks and probabilities looking forward, but Rule 10b-5 approaches its variant of probability analysis from after the fact, which exposes the trier of fact to the temptation of hindsight.

Probability is a key ingredient of both Item 303 and Rule 10b-5. In determining whether there is a duty to disclose, Item 303 factors in two probabilistic analyses—one entirely subjective, and one objective (with a healthy dose of deference). First, a company's management must determine whether a "known trend, demand, commitment, event or uncertainty" is "likely to come to fruition." If the answer to that question is uncertain, management must "evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty," and make a determination as to whether "a material effect on the registrant's financial condition or results of operations is . . . likely to occur." 1989 Guidance, 1989 WL 1092885, at *6. The first part of the inquiry is entirely subjective—unlike the subsequent step, there is no requirement that management evaluate factors "objectively" in determining the likelihood of the underlying event. And the second test accords deference to management's determination as to what is a "material effect" and whether it is likely to occur. *See* Crawford & Galaro, *supra*, at 1 (under Item 303, company management has "leeway to use their judgment").

Basic's probability/magnitude test requires a determination of likelihood, too—the trier of fact must

determine the "probability that the event will occur." *Basic*, 485 U.S. at 238. But unlike Item 303's two-part test, which looks at disclosure through "the eyes of management," 1989 Guidance, 1989 WL 1092885, at *3, *Basic*'s probability test looks at the question of likelihood through the eyes of "the reasonable investor" considering "the total mix of information," 485 U.S. at 231-32 (citation and internal quotation marks omitted).

Under the Second Circuit's conflation of Item 303 and Rule 10b-5, a trier of fact would be forced to make three determinations of likelihood. To determine whether a duty exists in the first place, the trier of fact must, "through the eyes of management," determine whether the event was likely to happen at the time management made the decision not to disclose. The trier of fact must also determine whether adverse effects were "reasonably likely" given information available to management at the time, still using the lens of management. Once the trier of fact has determined there is an Item 303 duty to disclose based on these factors, it must switch over to the materiality inquiry, and, using the lens of the "reasonable investor," determine whether the adverse event was "likely." These determinations would be made after the adverse trend or event has manifested itself in some form, as an investor could not sue if the adverse trend or event never materialized. *Cf. Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975) (wording of section 10(b) is "directed toward *injury suffered* 'in connection with the purchase or sale of securities'" (emphasis added)).

The problem with these *ex post* determinations, however, is that they are susceptible to hindsight bias,

perhaps incurably so. "Hindsight bias is the tendency to regard events that have already occurred as having always been inevitable." Kimberly Eberwine, Note, *Hindsight Bias and the Subsequent Remedial Measures Rule: Fixing the Feasibility Exception*, 55 Case W. Res. L. Rev. 633, 636 (2005) (citing Baruch Fischhoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. Experimental Psychol.: Human Perception & Performance 288-89 (1975)). Triers of fact who are exposed to knowledge of the outcome—here, the adverse event or trend—"remain anchored in the hindsightful perspective . . . leav[ing] the reported outcome looking much more likely than it would look to the reasonable person without the benefit of hindsight." Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post ≠ Ex Ante: Determining Liability in Hindsight*, 19 L. & Hum. Behav. 89, 90 (1995).

That bias would undermine the deference and flexibility inherent to Item 303. Instead of stepping into the shoes of management, as the SEC intended, the trier of fact would likely be fixated on the adverse trend or event's actual occurrence, and work its way backwards to finding likelihood for (1) the trend or event happening at all, a consideration for which management is owed complete deference; and (2) the trend or event having adverse effects, a factor for which management is owed at least *some* deference. *See id.* at 100 (concluding based on data that "merely encouraging participants to 'imagine alternative outcomes' may not be adequate for reducing [hindsight] bias"). No matter how many times a court instructs a jury to "step into the shoes of management," the trier of fact is likely to be wedded to "outcome knowledge," which "deeply affect[s] participants' interpretations of a com-

plex story." *Id.* at 99-100. Compounding the problem is the overlap in determining the likelihood of the trend or event, which is an element of both defining the duty under Item 303 and determining materiality under *Basic*'s probability/magnitude test. Despite the fact that the two tests use different standards (one deferential and one not), a trier of fact, already affected by hindsight bias, may be tempted to collapse the two inquiries into one.

Given these problems, it is unlikely that a trier of fact considering a Rule 10b-5 claim of omission predicated on an Item 303 duty to disclose will factor in the deference and flexibility that the SEC accorded to corporate management when it first implemented Item 303. Because the probability component of *Basic*'s materiality test is susceptible to the same hindsight bias as the question of whether a duty exists under Item 303 in the first place, it will not serve as an effective limitation on liability, as the Second Circuit suggests.

The only holding that will preserve the discretion, flexibility, and deference that the SEC intended for Item 303 is a holding that Item 303 is not a proper predicate for a Rule 10b-5 claim.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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