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 Petition for a 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.

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[1] All parties have consented to the filing of this brief. Written consents are on file with the Clerk. *Amici curiae* timely provided notice of intent to file this brief. 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.

§ 240.10b–5. They are also subject to Regulation S-K and, specifically, to Item 303, which calls for management to discuss and analyze certain "trends" and "uncertainties." 17 C.F.R. § 229.303. For decades, *amici*'s members and other issuers of publicly traded securities have understood that Item 303 is not actionable under Rule 10b-5, and have resolved any doubts about the scope of Item 303 consistent with that understanding.

The Second Circuit's recent decisions—which conflict with longstanding precedents of the Third, Sixth, and Ninth Circuits—have disrupted that understanding. In the Second Circuit, publicly traded companies are now exposed to potential liability for disclosures (and omissions) long thought to be beyond the reach of Rule 10b-5. If left to stand, the Second Circuit's ruling will perpetuate a state of confusion over how these companies disclose forward-looking information. *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

The Second Circuit erred in holding that Item 303 creates a "duty" to disclose that is actionable under Rule 10b-5. Although Item 303's provisions on forward-looking statements may be couched in seemingly mandatory terms, the breadth and amorphousness of Item 303's reporting standards make it almost impossible in many instances to determine when management is obligated to make a disclosure. As a result, the other circuits that have considered the issue have uniformly and correctly held that Item 303 cannot be enforced through the mechanism of a Rule 10b-5 action.

In addition to the circuit conflict, the decision below will create practicalities that undermine the directives of this Court. In *Basic Inc. v. Levinson*, this Court cautioned that Rule 10b-5 should not be interpreted in a way that would merely flood the market with unnecessary information. 485 U.S. 224, 234 (1988). That principle weighs heavily here: because Item 303's standard is so loose and so vague, corporate officers will rarely have the necessary certainty that a particular contingency can safely be omitted. And if any misapplication of the standard will result in a class action lawsuit (or many), then the natural reaction will be to put out more and more management discussion under the heading of Item 303—precisely what this Court cautioned against in *Basic*.

The Second Circuit's approach also strips away a key feature of Item 303: wide latitude given to management in deciding whether forward-looking information is sufficiently certain such that disclosure is warranted. Rather than looking at decisions to disclose through "the eyes of management," as the SEC intended, the Second Circuit presupposed that a duty to disclose exists pursuant to Item 303, giving no deference to the difficult judgments that management must make in making forward-looking statements and instead exposing management to hindsight claims of liability.

The split that the Second Circuit has created should be resolved as speedily as possible. Now that Item 303 is actionable in one circuit—indeed, the circuit that has seen the most securities class actions filed in its district courts—there will be a significant incentive for plaintiffs simply to file there. Further percolation may well be limited or nonexistent. And so long as the

Second Circuit precedent remains uncorrected, any publicly traded company that transacts any portion of its business in the Second Circuit will face an increased threat of private civil liability. This Court, therefore, should take this opportunity to resolve the split.

ARGUMENT

A. Item 303 is a difficult-to-apply provision that requires corporate officers to make a series of essentially predictive judgments.

By design, Item 303 is a provision requiring judgment calls about uncertain future events. Because the SEC wrote the provision to be "intentionally flexible," *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, SEC Release No. 6835, 1989 WL 1092885, at *17 (May 18, 1989) ("SEC Release"), it contains few bright lines. In many cases, what must be included under Item 303 depends on management's subjective predictions about what is "reasonably likely" to happen.

That subjective, uncertain standard of prediction makes Item 303 an inappropriate foundation for Rule 10b-5 liability. Allowing plaintiffs' lawyers to litigate such judgment calls under Rule 10b-5 would create a severe penalty for making a wrong guess about the future. The result would be to compel corporate officers to include more and more speculation about more and more contingent events, because any decision *not* to include a particular uncertainty may be subject to second-guessing by a jury at the behest of a private plaintiff.

1. Item 303 of Regulation S-K requires disclosure of a wide range of information concerning a company's "financial condition and result of operations," 17 C.F.R. § 229.303. Unlike Rule 10b-5, which uses a rule of materiality to winnow liability, materiality under Item 303 is designed to be capacious—to encourage management to disclose as much information as possible so that an investor has "an opportunity to look at the company through the eyes of management." SEC Release, 1989 WL 1092885, at *3. Those differing standards powerfully underscore why the substance of Item 303 and the procedural mechanism of the Rule 10b-5 private civil action are fundamentally a mismatch for one another. They cannot be judicially fused together into a new and uniquely plaintiff-friendly cause of action.

Indeed, both the SEC and the courts have repeatedly recognized the tension between the scope of what management is supposed to disclose under Item 303 and the scope of the materiality standard this Court applied in *Basic*. Because the scope of the former is much broader, the SEC itself called the *Basic* test "inapposite" in the Item 303 context: "The probability/magnitude test for materiality approved by the Supreme Court in [*Basic*] is inapposite." SEC Release, 1989 WL 1092885, at *6 n.27. And several circuits have agreed. *See, e.g.*, *In re NVIDIA Corp. Secs. Litig.*, 768 F.3d 1046, 1055 (9th Cir. 2014) ("Management's duty to disclose under Item 303 is much broader than what is required under the standard pronounced in *Basic*."); *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000) (Alito, J.) (noting that "the materiality standards for Rule 10b-5 and SK-303 differ significantly").

In essence, Item 303 considers whether a disclosure or omission *could be* material, not whether it *is* material. *See* SEC Release, 1989 WL 1092885, at *6 n.27 ("MD&A . . . specifies its own standard for disclosure—*i.e.*, reasonably likely to have a material effect."). Because "Item 303, at least in some cases, has a lower threshold for disclosure than does normal materiality, . . . disclosures required under Item 303 do not always implicate normal materiality standards." Brian Neach, Note, *Item 303's Role in Private Causes of Action Under the Federal Securities Laws*, 76 Notre Dame L. Rev. 741, 756 (2001).

2. The provision of Item 303 at issue here requires disclosure of "any known trends or uncertainties that have had or *that the registrant reasonably expects will have* a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." *Id.* § 229.303(a)(3)(ii) (emphasis added).

Determining whether disclosure is necessary under this aspect of Item 303 requires multiple steps. SEC Release, 1989 WL 1092885, at *6. Once a company's management determines that there is an "event, demand, commitment, trend or uncertainty," 17 C.F.R. § 229.303(a)(3)(ii); Pet. App. 18a, management has a "duty to assess the known information and evaluate whether the trend or uncertainty is likely to come to fruition." Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. Rev. 675, 730 (1999); *see* SEC Release, 1989 WL 1092885, at *6. If management cannot determine that the uncertainty or trend is "not reasonably likely to occur," it must assume that the "known trend, demand, commitment, event, or uncertainty" *will* come to fruition. SEC Release, 1989 WL 1092885, at *6. Management must then attempt to ascertain objectively, as of that moment in time, what consequences would be "reasonably likely" to arise in the future as a result of the "trend, demand, commitment, event, or uncertainty." *Id.*

The SEC has introduced a further complication. As the SEC stated in a 1989 release, there is a

> distinction between prospective information that is required to be discussed and voluntary forward-looking disclosure. . . . The distinction between the two rests with the nature of the prediction required. Required disclosure is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects*, such as: 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. In contrast, optional forward-looking disclosure involves *anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty*.

SEC Release, 1989 WL 1092885, at *4.

3. Thus, Item 303 asks management to make a series of difficult judgments: to start with (for example) an "uncertainty"; to assess how likely the uncertain contingency is to come about; and to assess whether, *if* it comes about sometime in the future, it is "reasonably

likely" to have a material effect at that future time. If so, the "uncertainty" must be written up under Item 303. But if the impact would instead be "less predictable," *id.*, then assessing it is "forward-looking" and disclosure is optional, not required. *Id.*[2]

It is difficult to discern when forward-looking information is sufficiently certain that it crosses the line from optional to mandatory. *See* 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."). Despite decades-old regulatory guidance, what Item 303 requires is still unclear. *See* Mark S. Croft, *MD&A: The Tightrope of Disclosure*, 45 S.C. L. Rev. 477, 478 (1994) ("Under Item 303 . . . the MD & A disclosure requirements are open-ended and exceedingly complex."); 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 this guidance from the SEC, the requirements under this section are flexible and complicated, leaving the company with a difficult task.").

4. The relevant history confirms that Item 303 was written to give flexibility—at the expense of clarity. Item 303 was not designed to create a litigation trip

[2] *Cf. Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1297-98 (9th Cir. 1998) (noting that "forward-looking statements" are "not required" under Item 303 and holding that prediction failure based on the known event of a slowdown was not actionable under section 12).

wire over difficult-to-foresee contingencies. Indeed, before the SEC adopted the regulation, courts had held that failure to disclose speculation—however likely the speculated-about outcome may be—was not actionable under the securities laws. *See, e.g.*, *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 relaxed its position in 1978, "encouraging, although not requiring, disclosures of management projections both in filings with the SEC and in general." *Isquith ex rel. Isquith v. Middle S. Utilities, Inc.*, 847 F.2d 186, 205 (5th Cir. 1988) (quoting *Guides for Disclosure of Projections for Future Economic Performance*, SEC Release No. 5992 (Nov. 7, 1978)). That position eventually evolved into the current rule, which mandates disclosure of *some* predictions while leaving the disclosure of others optional. But nothing in that history supports the notion that Item 303 could be weaponized by plaintiffs invoking Rule 10b-5.

B. The Second Circuit's decision contravenes this Court's holding in *Basic*, because it expands the scope of Rule 10b-5 liability in a way that will encourage flooding the market with "essentially useless" information.

By transforming Item 303 disclosures and omissions into a basis for Rule 10b-5 liability, the Second Circuit's decision threatens to spur what Rule 10b-5 seeks to limit in the first place: too much disclosure 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." *Basic*, 485 U.S. at 234. That not only squarely contradicts the decisions of other circuits, but undermines this Court's decision in *Basic*. This Court has made clear that Rule 10b-5 is not intended to be used in that fashion.

1. Rule 10b-5 provides a private cause of action for representations or omissions that are "material" and "misleading." *E.g.*, *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 38 (2011); *Basic*, 485 U.S. at 238. Omission alone is not enough for liability under Rule 10b-5; there also must be a corresponding duty to disclose. And the starting presumption is that there is no such duty. *Basic*, 485 U.S. at 237 n.17. Materiality also serves as a barrier to suit—information is material only when there is 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 the information made available." *Id.* at 231-32 (citation omitted).

The materiality rule is intended to "filter out essentially useless information that a reasonable investor would not consider significant, even as a part of a larger 'mix' of factors to consider in making his investment decision." *Id.* at 234 (citation omitted). Dumping too much information on an investor can create inefficiencies; the excessive information can serve as a roadblock to reasoned decisionmaking. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976). In discussing Rule 14a-9, this Court observed that "if the standard of materiality [for disclosure purposes] is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information." *Id.*

2. Opening up Rule 10b-5 liability for failures to disclose under Item 303 would encourage just the regime of over-disclosure that this Court admonished in *Basic*. Materiality is supposed to be a check on the incentive to over-disclose, but Item 303 contains a relatively weak concept of materiality. *See Oran*, 226 F.3d at 288 (explaining that "[b]ecause the materiality standards for Rule 10b-5 and SK-303 differ significantly, the demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5. *Such a duty to disclose must be separately shown.*" (emphasis added, citation and internal quotation marks omitted)); *accord In re NVIDIA Corp. Secs. Litig.*, 768 F.3d at 1055; Pet. 18 (submitting that an affirmative duty to disclose arises under Rule 10b-5 only in instances of insider trading or statements rendered misleading in the absence of omitted information). Allowing alleged violations of Item 303 to be litigated by private plaintiffs (via class actions) will strongly skew managers' behavior toward the overly cautious, self-preserving end of the spectrum.

And as discussed above, the overload of information an investor receives from an overly cautious management may not prove to be analytically useful. "[I]ndividuals who are accountable often overinterpret information, focus too much on less relevant information while ignoring key (or 'diagnostic') information, and pay too much attention to conflicting information in anticipation of criticism from the party they are accountable to." Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 Wash. U. L.Q. 417, 456-57 (2003). This overthinking tends to lead to the use of "an overly-complicated decision process that leads to an inferior result." *Id.* at 457.

The market already corrects for failures to disclose material and adverse forward-looking information (either because management decided incorrectly or because it deliberately withheld the information); upon discovering such news, "the market will penalize the company later by devaluing its securities (to account for the risk that the company might be holding out on additional bad news not yet known to the public)." Gulati, *supra*, at 690. Compelling maximum disclosure under Item 303 is not only unnecessary, but harmful to the market's self-regulation. *Id.* ("Because the market itself disciplines firms, through the imposition of non-legal sanctions such as reputational costs, the creation of legal sanctions is largely unnecessary to force appropriate disclosures and, in fact, is positively detrimental to a well-functioning market . . . .").

C. The Second Circuit's decision undermines management's ability to make judgment calls about which forward-looking information warrants disclosure under Item 303.

The Second Circuit's ruling threatens to render meaningless a fundamental protection in Item 303: the ability of management to make judgment calls—and, sometimes, mistakes—when engaging in the prognostication exercise that Item 303 demands. *See*

Denise Voigt Crawford & Dean Galaro, *A Rule 10b-5 Private Right of Action for MD&A Violations?*, 43 Sec. Reg. L.J. 1 (2015) ("Regulation S-K gives registrants leeway to use their judgment in disclosing pertinent trends and uncertainties."). Because the disclosure-worthiness of a forward-looking statement pursuant to Item 303 is difficult to discern, the plain text of Item 303 affords deference and leeway to management's decisions to disclose. *See id.* (explaining that Item 303, "[i]n casting a wide net," is "somewhat deferential"). For instance, disclosure under Item 303 is necessary when "*the registrant* reasonably expects" trends or uncertainties "will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii). And it is management that must determine at the outset whether the "trend, demand, commitment, event, or uncertainty" is "reasonably likely to occur." SEC Release, 1989 WL 1092885, at *6. Although the deference is not limitless and is checked by objective standards of reasonableness, there is little question that Item 303 imbues a "business judgment layer of protection." Gulati, *supra*, at 726 & n.148 (citing *SEC v. Tex. Gulf Sulphur*, 401 F.2d 833, 850 n.12 (2d Cir. 1968)).

The Second Circuit's holding—that "Item 303 imposes an 'affirmative duty to disclose . . . [that] can serve as the basis for a securities fraud claim under Section 10(b)," Pet. App. 16a n.7; *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 101 (2d Cir. 2015)—strips away the protections for management that lie at the core of Item 303. Management releases or withholds forward-looking information on the assumption that it is given wide latitude on its decisions to disclose. But that latitude and the appreciable difficulty of navigating the elusive standards of Item 303 are given no weight under the Second Circuit's approach—instead, that approach simply presumes "Item 303 imposes the type of duty to speak that can . . . give rise to liability under Section 10(b)" with the principal limitation being only the probability/magnitude standard of materiality announced by this Court in *Basic* and rejected as "inapposite" by the SEC. *See Stratte-McClure*, 776 F.3d at 103.[3] Should the Second Circuit's decision stand, the threat of liability over potentially trivial forward-looking information will effectively transform the standard for Item 303 disclosure from information divulged as a result of the difficult judgments made "through the eyes of management" to information viewed by a reasonable investor that gives no deference to the management's judgment and has the benefit of hindsight. That approach will encourage disclosures that this Court sought to guard against in *Basic*: the flooding of "useless information." 485 U.S. at 234. Neither standard of materiality—Item 303 or Rule 10b-5—is served by the Second Circuit's tack.

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[3] *See also Basic*, 485 U.S. at 238 (with "contingent or speculative information or events," "materiality 'will depend at any given 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.'" (quoting *Texas Gulf Sulphur*, 401 F.2d at 849)); SEC Release, 1989 WL 1092885, at *6 n.27 ("The probability/magnitude test for materiality approved by the Supreme Court in [*Basic*] is inapposite."). The *Basic* Court's reliance on the *Texas Gulf Sulphur* probability/magnitude test reaffirms the importance of recognizing the latitude given to management in making (or refraining from making) disclosures; *Texas Gulf Sulphur* appreciated that "the timing of disclosure is a matter for the business judgment" of company management. 401 F.2d at 850 n.12.

D. The Second Circuit's decision to fall out of step with multiple other circuits warrants immediate review.

The conflict that the Second Circuit has created should be resolved immediately. The adoption of a new form of private civil liability based on financial statements, even by a single circuit, can have an outsized effect on publicly traded companies throughout the United States. And when that out-of-step circuit is the Second Circuit, which hears more securities appeals than any other circuit, the nationwide impact is all the clearer. This Court should not wait to resolve the conflict.

A circuit's decision to create what is in essence a new private cause of action encourages plaintiffs to file suit in that circuit. Venue is essentially no obstacle to the filing of a securities class action: the Exchange Act provides for nationwide service of process and allows plaintiffs to bring suit in any district "wherein the defendant is found or is an inhabitant or transacts business." 15 U.S.C. § 78aa(a). Because of that liberal standard, few publicly traded companies are *not* subject to suit within the Second Circuit under the Exchange Act. The fact that the same suit cannot *also* be filed in Philadelphia or San Francisco is little comfort for the CFOs and other corporate officers who must complete and sign disclosures.

Even if the Second Circuit's erroneous rule were not an incentive to file there, the Second Circuit *already* carries disproportionate weight in securities matters. *See* Pet. 9 & n.3. Over the last 20 years, more securities class actions have been filed in the district courts of the Second Circuit than in any other circuit. *See*

Stanford Law School, Securities Class Action Clearinghouse, *Filings Database*, http://securities.stanford.edu/circuits.html. The Second Circuit tops the most recent statistics on securities appeals as well. *See* Administrative Office of the U.S. Courts, *Federal Judicial Caseload Statistics 2015*, tbl. B-7, at 2, http://www.uscourts.gov/file/18492/download.

Based on the erroneous circuit precedent below, more securities class actions filed throughout the Second Circuit will survive dismissal. "[E]xtensive discovery and the potential for uncertainty and disruption" will "allow plaintiffs with weak claims to extort settlements from innocent companies." *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163 (2008). And because of the incentives to sue in the Second Circuit and reach a settlement, fewer cases presenting this issue will reach the appellate level. The time for this Court to resolve the conflict, therefore, is now.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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