No. 16-581

IN THE
Supreme Court of the United States

LEIDOS, 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 OF INSTITUTIONAL INVESTORS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICI

This brief is filed by institutional investors that collectively manage more than $100 billion of assets in carrying out their obligations to over 750,000 individuals. Those investors — whose assets are at risk from securities fraud — have a vital interest in the question presented by this case.[1]

Amici include:

- Los Angeles County Employees Retirement Association (LACERA), which administers defined retirement plan benefits for the employees of Los Angeles County and outside Districts. It has over 165,000 members, including close to 62,000 benefit recipients, and more than $50 billion in assets under management.
- The Philadelphia Public Employees Retirement System provides defined retirement benefits to police, fire and civilian workers of the City of Philadelphia through the administration of multiple pensions plans. The System has approximately 66,000 members and roughly $4.8 billion in assets under management.
- The Colorado Public Employees' Retirement Association provides retirement and other benefits to its 560,000 members who are employees and former employees of government agencies and public entities in the

[1] Letters of consent have been filed with the Clerk. Pursuant to Supreme Court Rule 37.6, *amici* state that no counsel for a party authored any part of this brief, and no person or entity other than *amici* and their counsel made a monetary contribution to the preparation or submission of this brief.

State of Colorado. Colorado PERA has approximately $47 billion in assets under management.

Both Congress and this Court have recognized the important role played by institutional investors, and public pension funds in particular, in enforcing the securities laws. Institutional investors contribute a substantial portion of the capital invested in the nation's securities markets. In the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995), Congress endorsed a leading role for institutional investors in the private enforcement of the securities laws. Congress did so because institutional investors have a long-term perspective that aligns their interests with those of the companies in which they invest. Institutional investors have no interest in meritless securities litigation, which only harms their own investments, but they have a strong interest in policing fraud and deterring misconduct that damages shareholders and the integrity of the markets.

Amici believe that private enforcement of SEC disclosure requirements is essential to the proper functioning of capital markets. In particular, the disclosure requirements of Item 303 of SEC Regulation S-K, 17 C.F.R. § 229.303, are among the few requirements for registrants to provide investors key information about trends and uncertainties known at the time to management that could affect the underlying business. Institutional investors rely on the completeness of these disclosures. Investors are misled when they receive a disclosure that purports to be complete in identifying the known trends and uncertainties, but in fact is not.

SUMMARY OF ARGUMENT

I. This Court has long recognized that private enforcement of the securities laws is a "necessary supplement" to the SEC's regulatory and enforcement authorities. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (citations omitted). Congress has endorsed a leading role for institutional investors, and public pension funds in particular, in the private enforcement of the securities laws. Because institutional investors manage a substantial amount of funds, they have an important stake in securities litigation and the proper functioning of our nation's capital markets. These funds invest for the long term and have no interest in furthering meritless litigation. They also have an intense interest in preventing fraud and ensuring that companies comply with the SEC's disclosure requirements.

II. Petitioner concedes that Item 303 of Regulation S-K creates a legal obligation to make complying disclosures; Petitioner simply denies that the obligation is enforceable by private plaintiffs under Section 10(b) and Rule 10b-5. However, Item 303 is precisely the sort of disclosure requirement that should be understood to impose an actionable duty subject to private enforcement. Institutional investors rely on the accuracy and completeness of Item 303 disclosures. Although some disclosure requirements call for boilerplate recitations of past events unlikely to affect investors' decisions, Item 303 is different. It enables investors to see the company through management's eyes. By requiring registrants to disclose trends and uncertainties known to management, Item 303 reassures investors that they share management's understanding of the factors that could affect the bottom line. This case is

not about harmless or trivial violations of line-item disclosure requirements.

Petitioner argues that allowing for the private enforcement of these duties will result in investors being deluged with useless information. But the disclosures required by Item 303 are the kind that most interest institutional investors. The risk of confusing investors with too much information is overstated and unduly paternalistic. Petitioner's argument conflicts with the fundamental purpose of the securities laws, which was to replace the philosophy of caveat emptor with a philosophy of full disclosure—a purpose repeatedly recognized by this Court. If investors cannot enforce a company's legal obligation to disclose, even when information is hidden with the goal of defrauding investors, then the philosophy of full disclosure would be severely undermined and the integrity of capital markets called into question.

This case does not involve a novel claim, but only an application of established principles to a slightly different situation – Item 303. Many of this Court's leading cases under Section 10(b) and Rule 10b-5 involved omissions of information. When the law creates a "duty to disclose" certain information, that duty is "the element required to make silence fraudulent." *Chiarella v. United States*, 445 U.S. 222, 232 (1980). While the Court has been reluctant to create disclosure duties untethered to any legal requirement, *see Dirks v. SEC*, 463 U.S. 646, 657-59 (1983), here Item 303 is already a disclosure requirement created by federal law. Moreover, the law requires corporate leaders to sign certifications verifying the completeness of these disclosures. If a registrant nevertheless omits critical information, and does so with an intent to deceive investors, then

investors who relied on the completeness of those disclosures may have a valid claim under Section 10(b) and Rule 10b-5, if the other elements of the cause of action are satisfied.

III. Petitioner's policy-based arguments lack merit. As the materials cited by Petitioner demonstrate, the SEC's process of providing informal comments on Item 303 disclosures can provide prospective assistance to registrants that are acting in good faith. But this process is not geared toward uncovering critical information that registrants have intentionally hidden from investors. To address that problem, private enforcement is necessary.

Petitioner contends that permitting enforcement of Item 303 will result in a "flood" of litigation. Citing dubious statistics, it argues that filings have increased as a result of the Second Circuit's decision in *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2015). Upon closer inspection, however, the statistics show no such thing, and Petitioner's scare tactics do not withstand scrutiny.

The judgment below should be affirmed.

ARGUMENT

I. INSTITUTIONAL INVESTORS, INCLUDING PUBLIC PENSION FUNDS, PLAY AN IMPORTANT AND CONGRESSIONALLY RECOGNIZED ROLE IN SECURITIES LITIGATION.

This Court has long recognized that private actions to enforce the securities laws are a "necessary supplement" to SEC enforcement actions. *See Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (citations omitted); *Blue*

Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). "The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 778 n.10 (2008) (quoting S. Rep. No. 104-98, at 8 (June 19, 1995)). This Court has consistently—and often unanimously—avowed that "'private securities litigation [is] an indispensable tool with which defrauded investors can recover their losses'—a matter crucial to the integrity of domestic capital markets." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 320 n.4 (2007) (8-1) (quoting *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,* 547 U.S. 71, 81 (2006) (citation omitted) (8-0)).

Institutional investors, including public pension funds in particular, play a key role in the private enforcement of the securities laws. In the aggregate, pension funds that invest in U.S. markets cover tens of millions of active and retired members and control trillions of dollars in assets. Each year these funds invest billions of additional dollars in the U.S. capital markets on behalf of their beneficiaries.

As institutional investors, pension funds have a long-term outlook and an interest in deterring meritless litigation. Their overriding responsibility is to invest for the retirement and long-term security of their millions of active and retired members. Institutional investors – and, we believe, all investors – are vitally concerned that investors not be harmed by the illegal conduct of those who issue and sell publicly traded securities.

Because institutional investors are typically under an obligation to protect the investments they make on behalf of their millions of beneficiaries, these *amici* have a particularly significant interest in redressing violations of the federal securities laws. Indeed, it is doubtful that any party has a greater stake in the substantive requirements for securities class actions than institutional investors, who are concerned about securities fraud as much as, if not more so than, individual investors—and who have much more at stake.

Further, many state and local governments are constitutionally obligated to guarantee defined-benefit retirement plans. Therefore, in many cases, taxpayers would be on the hook if investment funds suffered losses due to the chicanery and malfeasance of the issuers of publicly traded securities.

Congress recognized and endorsed a leading role for institutional investors, including public pension funds, in the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 (1995). The PSLRA was born of congressional frustration with what it perceived as "nuisance filings." *Dabit,* 547 U.S. at 81; *see also Tellabs,* 551 U.S. at 320. Accordingly, Congress acted "to increase the likelihood that institutional investors—parties more likely to balance the interests of the class with the long-term interests of the company—would serve as lead plaintiffs" in securities class actions. *Tellabs*, 551 U.S. at 321. Congress founded this policy on its conviction that "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Rep. No. 104-369, at 34 (1995) (Conf. Rep.).

The PSLRA adopted new methods for judicial selection of lead plaintiffs and lead counsel in securities class actions. *See id.* These reforms were designed to encourage the selection of institutional investors as lead plaintiffs precisely because such entities are "deemed to have a large enough financial interest in the litigation and sufficient professional expertise in directing litigation to ensure that class members' interests are competently and dutifully served." Mary K. Kane, *et al.*, WRIGHT & MILLER ON FEDERAL PRACTICE & PROCEDURE § 1808 at n.22 (2012). "Institutional investors, [Congress] believed, are less likely to bring abusive or meritless litigation." *Id.* at n.23.

Congress deliberately favored institutional investors in the PSLRA. The PSLRA creates a rebuttable presumption for the appointment as lead plaintiffs of investors who have the "largest financial interest" in the relief sought by the class. *See In re Cendant Corp. Litig.,* 264 F.3d 201, 222 (3d Cir. 2001); *In re Cavanaugh,* 306 F.3d 726, 729-30 (9th Cir. 2002). "Congress prescribed new procedures for the appointment of lead plaintiffs and lead counsel. This innovation aimed to increase the likelihood that institutional investors—parties more likely to balance the interests of the class with the long-term interests of the company—would serve as lead plaintiffs." *Tellabs,* 551 U.S. at 320-21. *See also* Mary K. Kane, *et al.*, WRIGHT & MILLER FEDERAL PRACTICE & PROCEDURE § 1806 (2012); Charles M. Silver & Sam Dinkin, *Incentivizing Institutional Investors to Serve As Lead Plaintiffs in Securities Fraud Class Actions*, 57 DEPAUL L. REV. 471 (2008).

Thus, at the same time that Congress *discouraged* meritless securities class actions, *see* 15 U.S.C. § 78u-4(a)(3)(B)(vi), Congress *encouraged*

class actions brought by institutional investors such as the *amici* (and lead plaintiff) here because they "do not represent the type of professional plaintiff this legislation seeks to restrict." H.R. Rep. No. 104-369, at 35 (1995).

II. ITEM 303 IS EXACTLY THE KIND OF DISCLOSURE STANDARD THAT SHOULD IMPOSE AN ACTIONABLE DUTY UNDER RULE 10B-5.

Regulation S-K requires registrants to include a "narrative description" or analysis of their business operations. The section of disclosures relating to "Management's Discussion and Analysis of Financial Condition and Results of Operation" ("MD&A") is frequently one of the most-read portions of the disclosures. When management omits material information from its MD&A disclosures with the intent to deceive investors, that unlawful omission can form the basis of a valid claim under Section 10(b) and Rule 10b-5. The MD&A disclosures are not minor or technical disclosure requirements. Rather, they are investors' opportunity to understand the principal risks and challenges that a company faces, as known to management. Petitioner argues that the Court should be more concerned about inducing too much disclosure, but this paternalistic view is not the one taken by the securities laws, which are premised on a philosophy of full disclosure.

A. Institutional Investors Find Item 303 Information Highly Relevant To Their Investment Decisions.

Item 303 requires issuers to disclose, as part of management's discussion and analysis in various regulatory filings, "any known trends or uncertainties that have had or that the [issuer] reasonably expects 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). To meet those obligations, "companies must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance." SEC Release No. 34-48960, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation*, 68 Fed. Reg. 75056, 75057 (Dec. 19, 2003). These mandatory disclosures play an important role in institutional investors' assessment of a company because they "enable[] investors to see the company through the eyes of management." *Id.* at 75056. Unlike other disclosure requirements, the MD&A is not limited to a retrospective look at a company's performance, but also "call[s] for companies to provide investors" with information about their "prospects for the future." *Id.* at 75059.

Of the many mandatory disclosures required by the SEC, Item 303's are among the most important. As the SEC has acknowledged, the disclosure of "known trends or uncertainties" is "[o]ne of the most important elements necessary to an understanding of a company's performance, and the extent to which reported financial information is indicative of future results." *Id.* at 75061. Institutional investors

routinely review these disclosures before making investment decisions, and rely on their accuracy and completeness. In fact, to most investors, information about "trends and uncertainties" is considerably *more* important than boilerplate reports of things that have already happened. Factual information about the past is important, but it is often available elsewhere and likely would already be reflected in the price of the stock. In contrast, the MD&A provides unusually valuable insight into how management understands the risks that the company faces. Unlike many other required disclosures, Item 303 does not concern esoteric or hypertechnical details. Rather, it gives investors a window into the business "as seen through the eyes of those who manage that business." *Id.* at 75056.

Petitioner's brief inadvertently proves the importance of complete Item 303 disclosures when it uses this case as an illustration. Pet. Br. 46. Petitioner claims that SAIC's 145-page 10-K filing provided "a comprehensive and robust discussion of its business and operations." The MD&A section alone was 16 pages. Petitioner implores the court to "[i]magine how much longer, and less useful, public filings would be if registrants were required to interpose lengthy and lawyerly disclosures" of additional matters. *Id.*

But the filing in question omitted perhaps the most important information that investors would have wanted to know: that SAIC personnel had been implicated in a multimillion-dollar fraudulent scheme known as the "CityTime" scandal. By the time SAIC submitted its 10-K on March 25, 2011, the State of New York had denied SAIC a contract on the basis of its involvement in the fraud, as had the City of New York; multiple indictments had been

issued; SAIC had received grand jury subpoenas and placed its deputy project manager on administrative leave; and the company had hired an outside law firm to investigate the fraud. Yet SAIC did not disclose the CityTime scandal in its March 25, 2011 10-K report, in the MD&A section or anywhere else.

SAIC was a company heavily reliant on government contracts, and evidence that it had fraudulently billed New York City's government on a $600 million contract likely would affect its ability to attract new business. An accurate disclosure of the ongoing investigation and management's understanding of the risk to SAIC would have helped investors to evaluate SAIC's prospects and profitability.

Citing the requirement of Item 103 to disclose "pending legal proceedings," Petitioner argues that "[l]egal proceedings … generally do not fall within Item 303 at all." Pet. Br. 50-51. Petitioner is wrong. Item 103 requires disclosure only of "pending" litigation or specific "proceedings known to be contemplated by government authorities." 17 C.F.R. § 229.103. Unlike the MD&A requirements, these disclosures are retrospective. The SEC's guidance regarding Item 303 disclosures explicitly notes that potential environmental liability is a "common disclosure issue," and states that, if the EPA designates a company a potentially responsible party, "disclosure . . . would be required" even if the company is still "in the process of preliminary investigations of the sites." SEC Release No. 34-26831, 1989 WL 1092885, at *6 (May 18, 1989). Thus, a potential legal liability is an entirely appropriate subject for disclosure under Item 303, even if disclosure is not required under Item 103.

B. Petitioner's Paternalistic Arguments About Over-Disclosure Miss The Mark.

Petitioner argues that allowing private investors to enforce Item 303's duty to disclose would cause companies to include unnecessary and trivial information in their Item 303 disclosures. Petitioner makes the paternalistic argument that investors would be better off without such disclosures. Institutional investors are the ones most directly affected by Petitioner's concern, and they emphatically reject the premise that ignorance is preferable to disclosure.

This Court has "recognized time and again, a 'fundamental purpose' of the various Securities Acts, 'was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.'" *Basic, Inc. v. Levinson*, 485 U.S. 224, 234 (1985) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977). Although the Court has cautioned against adding requirements for disclosures of trivial information, it has not done so at the cost of this fundamental purpose. The law requires all registrants to make the disclosures required by Regulation S-K, including those mandated by Item 303.

The risk of overdisclosure is exaggerated. Institutional investors are sophisticated and able to judge for themselves the importance of information included in periodic reports. As the Court has recognized, investors are not "'nitwits,'" and courts should be careful not to attribute to them "'a child-

like simplicity.'" *Basic*, 485 U.S. at 234 (quoting *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987)). The disclosures required by Item 303 are precisely those that are of greatest interest to investors, because they show investors the key contingencies that could affect the company's outlook. The discovery of shady dealings, with its potential for long-term damage to the company's business and reputation, is precisely the sort of information upon which sophisticated investors would rely most heavily. *See Flamm*, 814 F.2d at 1175 ("These new events — things with potential for boom or bust — are exactly the news on which sophisticated investors make most decisions; 'old' news, with settled value, already is reflected in the price of the stock and so is no news at all.") "Disclosures to the market as a whole cannot be limited to what is fit for rubes," *id.*, and investors are already, by law, entitled to disclosure of the information mandated by Item 303.

Registrants are protected from liability by the strict materiality requirement that applies to claims under Rule 10b-5. That materiality standard is higher than the applicable standard under Item 303 and ensures that registrants will not be held liable for failing to make trivial disclosures. The Court has recognized the risk that a higher bar could cause issuers to "bury the shareholders in an avalanche of trivial information." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976). Registrants are thus liable under Rule 10b-5 only if the omitted information would be "considered significant to the trading decision of a reasonable investor." *Basic*, 485 U.S. at 236. Hence, to the extent that allowing private enforcement of Item 303 creates a risk of over-disclosure, the Court's longstanding

jurisprudence relating to materiality will screen out cases that lack merit.

C. Petitioner Is Wrong In Arguing That The Claim In This Case Should Be Rejected As Unduly Novel.

Petitioner contends that the securities fraud claim in this case is novel and urges this Court not to expand the scope of Rule 10b-5. Petitioner's argument is misplaced.

1. Securities Fraud Claims Were Not Frozen As Of 1933 and 1934.

First, the legal contours of securities fraud claims were not frozen as of 1933 and 1934. Institutional investors rely on the ability of courts and the Commission to apply Rule 10b-5 to new kinds of fraudulent schemes. Even if Petitioner were correct that the claim in this case is "novel" (and Petitioner is not), this Court has "repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate their remedial purposes.'" *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983) (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963)).

Thus, when Congress adopted the PSLRA and "accepted the [Rule 10b-5] private cause of action as then defined," *Stoneridge*, 552 U.S. at 166, this Court had already made clear that the proscriptions of Section 10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive." *Affiliated Ute*, 406 U.S. at 151. This Court had already recognized that Section 10(b) does not mandate the precise "contours of a private

cause of action under Rule 10b-5," and leaves to the courts the task of "flesh[ing] out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

Moreover, Petitioner's crabbed view of Rule 10b-5 would not simply impair the interests of institutional investors and other private plaintiffs. It would also limit the enforcement jurisdiction of the Securities and Exchange Commission. Yet Section 10(b) has been "described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976) (quoting Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934)). Because it is intended to address "the full range of ingenious devices that might be used to manipulate securities prices," *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977), Section 10(b) must be interpreted broadly and flexibly to address new forms of fraud that may emerge.

2. This Case Involves The Application of Settled Principles To The Context Of Item 303 Disclosures.

This case does not involve a novel securities fraud claim, but rather the application of familiar principles to the context of Item 303. Section 10(b) is a broad provision prohibiting the use of "any . . . deceptive device." When a company files an annual 10-K that purports to comply with the securities laws but in fact omits material information that

would be critical to institutional investors (and indeed all investors), that company has committed a "deceptive" act. Indeed, every 10-K filing includes an affirmative certification from corporate officers that the filing with the SEC "fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act [o]f 1934." 18 U.S.C. § 1350.[2]

Institutional investors take note of these certifications and assume that corporate officers can be taken at their word when they assure investors that all required information has been disclosed. In that respect, this case is a straightforward securities fraud action, and the complaint against SAIC need not be understood exclusively as an "omissions" claim. *See* Donald C. Langevoort and G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1680 (2004) ("[A] deliberate omission has the same potential to mislead [as an affirmative misrepresentation] – the reader of the disclosure sees that the issuer is responding to the disclosure obligation and is entitled to assume that the response is not only accurate but complete as well.").

Moreover, even if the case against SAIC were seen as purely an "omissions" case, Rule 10b-5 itself explicitly prohibits "omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Accordingly, this Court has consistently recognized that a party can

[2] Item 303 implements the requirements of Sections 13(a) and 15(d) that issuers file with the SEC periodic reports containing information that the Commission determines is required.

be held liable under Rule 10b-5 for unlawfully failing to disclose information that the party has a duty to disclose. Indeed, many of the Court's most important cases in this area have involved claims that information was unlawfully withheld from investors. *See Affiliated Ute*, 406 U.S. at 153 ("The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market."); *Basic*, 485 U.S. at 240 (remanded to determine whether omission was material). In *Basic*, the Court acknowledged that, "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5." 485 U.S. at 239 n.17. But the converse is also true: if the law creates a duty to disclose, silence can form the basis of a fraud claim.[3]

[3] In *Chiarella*, the Court addressed liability for omissions under Rule 10b-5, and recognized that a "duty to disclose" is "the element required to make silence fraudulent." 445 U.S. at 232. Contrary to Petitioner's argument, that statement is not limited to duties created by state law relating to a special relationship between the parties. Other statements in *Chiarella* strongly suggest that the Court understood that any duty to disclose under the securities laws would suffice to create an obligation to speak under Rule 10b-5. Referring to Chiarella's reliance on inside information when trading in a stock, the Court found that his use of the inside information "was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading." *Id.* at 231. In a footnote, the Court acknowledged that, "[a]s regards securities transactions, the American Law Institute recognizes that 'silence when there is a duty to . . . speak may be a fraudulent act." *Id.* at 228 n.9 (quoting ALI, Federal Securities Code § 262(b) (Prop. Off. Draft 1978)).

III. PETITIONER'S POLICY ARGUMENTS ARE INCORRECT.

Petitioner insists that a registrant cannot be liable, or subject to SEC enforcement, under Rule 10b-5 for material information intentionally omitted, with the intent to deceive investors, even when Item 303 mandates disclosure of that information, and even when investors relied on the completeness of the disclosure. Rather than allowing private investors and the SEC to enforce required disclosures using Rule 10b-5, Petitioner contends that issuers can violate their duty with impunity, even when the information is material and the issuer intentionally hides it from investors. Such an extreme position would dramatically weaken the enforcement – both private and regulatory – of the securities laws, and institutional investors have a strong interest in having this Court reject Petitioner's far-reaching position.

Petitioner seeks to justify its view with policy arguments. It maintains that enforcing Item 303's disclosure requirements would prevent effective regulatory enforcement of Item 303 and create a flood of "hindsight-driven" litigation. These arguments are incorrect, and the facts cited by Petitioner actually show the need for private enforcement, in appropriate circumstances, of Item 303's disclosure requirements.

We reiterate that institutional investors and public pension funds have a strong interest in deterring meritless litigation. They hold long-term stakes in public companies, and they have no interest in seeing those companies victimized by abusive litigation. However, institutional investors are also concerned that they and other investors not

be harmed by fraud and illegal conduct. *Amici* believe that the proper balance between these two competing interests lies in the adoption of Respondents' position and the rejection of Petitioner's position.

Petitioner's hostility to private securities litigation is also unwarranted, given the Court's admonition that "'private securities litigation [is] an indispensable tool with which defrauded investors can recover their losses'—a matter crucial to the integrity of domestic capital markets." *Tellabs,* 551 U.S. at 320 n.4 (quoting *Dabit*, 547 U.S. at 81). Institutional investors rely on the integrity of capital markets in making their investments, and this Court should not take any steps that would undermine investor confidence in the reliability and security of U.S. markets.

A. Regulatory Enforcement Is Not Sufficient To Police The Unlawful Omission Of Material Information With The Intent To Defraud.

Petitioner's brief describes the SEC's worthy efforts to improve the quality of MD&A disclosures, but also reveals the insufficiency of relying solely on the Commission to enforce these requirements. As Petitioner shows, the SEC does routinely comment on deficiencies in registrants' MD&A, and those comments can result in prospective changes that enhance MD&A disclosures. On the other hand, the staff comment letters cited by Petitioner reveal a process geared toward improving disclosures by firms acting in good faith. For example, the letter to Universal Hospital Services cited by Petitioner simply implores the company to clarify several

issues and provide investors with quantitative estimates about the potential impact of certain factors identified in the disclosure.

Amici institutional investors do not doubt the value of these informal discussions, which can help to ensure that investors receive more fulsome disclosures from registrants. But these informal comment letters cannot be expected to root out information that management has deliberately hidden from investors. Petitioner does not provide examples of staff comment letters addressing information fraudulently omitted from MD&A disclosures, and the informal comment process cannot be expected to provide adequate deterrence and punishment for cases involving intentional deception. After all, the SEC did not question the inadequate MD&A disclosure at issue here.

Petitioner argues that the dearth of SEC enforcement actions shows the success of the informal commenting process. According to Petitioner, the SEC has brought fewer than 100 enforcement actions under Item 303 in 40 years, a rate of just over two per year. These statistics support Respondents rather than Petitioner. It defies belief to suggest that this number constitutes any more than a trivial share of the periodic reports that unlawfully omitted information in violation of Item 303. The far more plausible inference is that the SEC is making the most of the limited resources available to it. *See In re Nat'l Presto Indus., Inc.*, 347 F.3d 662, 664 (7th Cir. 2003) ("Federal agencies have limited resources, and the SEC in particular is often outgunned by the affluent defendants that it sues.").

Petitioner argues that enforcement of Item 303's disclosure requirements should be left entirely to the SEC, but the Court's precedent makes clear that private enforcement need not interfere with the Commission's authority. Given the limited resources available to the SEC, the Court has long recognized that private actions to enforce the securities laws are a "necessary supplement" to the Commission's enforcement actions. *See* Part I, *supra.* Institutional investors strongly believe in the need for private enforcement of the securities laws.

Petitioner argues that Item 303 should be enforced exclusively by the SEC, but its position would actually *deprive* the SEC of its traditional authority to use Section 10(b) and Rule 10b-5 to fight and deter fraud. Petitioner's narrow understanding of liability for Item 303 omissions would not just affect private investors, but also would hamstring the Commission's efforts to address fraudulent omissions. It is not plausible to suggest that taking away a critical tool from the Commission will enhance regulatory enforcement.

In any case, the availability of SEC enforcement of Regulation S-K does not mean that private litigation is precluded. Rather, "[t]he SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws." *Stoneridge*, 128 S. Ct. at 778 n.10 (quoting S. Rep. No. 104-98, at 8 (June 19, 1995)).

B. Affirming The Second Circuit Will Not Result In A Flood Of 10b-5 Litigation.

Petitioner next contends that, since its decision in *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015), "the Second Circuit has been flooded with . . . Item 303 cases." Pet. Br. 47. This supposed "flood" consists of "*nearly* two dozen" cases, *id.* (emphasis added), brought over a period of more than two years. But Petitioner's count is inflated. It treats related, follow-on complaints against the same defendant as independent actions, so that five related complaints against the same defendant are treated as five cases, four related complaints as four cases, and two related complaints as two cases. *See* Cert. Reply Br. App. 1a–3a. When this over-counting is remedied, Petitioner's list shrinks to 14 cases over 30 months – hardly a "flood."

More fundamentally, victims of fraud (including *amici* institutional investors) have every right to sue to vindicate their rights under the securities laws when they have been deceived. Congress has made the wise judgment that the fraud, not the resulting lawsuit, is the social cost to be minimized. Indeed, fraud damages the integrity of capital markets on which an efficient allocation of economic resources depends.

In any event, the available evidence shows that *Stratte-McClure* has not created a tsunami of Rule 10b-5 litigation. This is in part because, over the past 40 years, Congress and the Court have adopted strict requirements for pleading and proving a cause of action under Section 10(b). These requirements, including scienter and materiality, apply with no less force to claims based on a violation of Item 303's disclosure requirements. The statistics cited by

Plaintiffs show that the growth in case filings is unrelated to the issue in this case, and that liability for Item 303 disclosures need not result in runaway litigation. For decades, courts and commentators have discussed the issue of liability for Item 303 omissions. If such liability would result in a flood of litigation, it would have happened by now.

1. To Succeed On A 10b-5 Claim, It Is Not Sufficient To Allege An Item 303 Omission By Itself.

Petitioner downplays other elements of Rule 10b-5 that limit the kinds of claims plaintiffs can bring. *Amici* institutional investors are keenly aware that not every omission or misrepresentation will result in liability under Rule 10b-5; a plaintiff must show much more to survive a motion to dismiss. In particular, the elements of a claim under Rule 10b-5 are: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Stoneridge*, 552 U.S. at 157. An omission in violation of Item 303 merely establishes part of the first element. A plaintiff must still show materiality and scienter, both of which are often high bars. Indeed, under the PSLRA, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

The Second Circuit's decision in *Stratte-McClure* illustrates how the other requirements of a Section 10(b) cause of action can limit the impact of

liability for Item 303 omissions. Although the court found that "Item 303 imposes the type of duty to speak that can . . . give rise to liability under Section 10(b)," 776 F.3d at 102, it nevertheless found that the plaintiff in that case had failed to state a claim. The court assumed for the sake of argument that the plaintiff had established a material omission under the standard adopted by the Court in *Basic*. Nevertheless, the plaintiff did not plead facts sufficient to establish a "strong inference" that the company acted with the requisite mental state. To meet that requirement, the court found, "Plaintiffs must allege that Defendants were at least consciously reckless regarding whether their failure to provide adequate Item 303 disclosures . . . would mislead investors about material facts." *Id.* at 106. The complaint failed to do that, because it was "silent about when employees realized that the more pessimistic assessments of the market were likely to come to fruition." *Id.* at 107.

Petitioner acknowledges these "significant hurdles" to stating a claim based on Item 303 omissions, Pet. Br. 49 n.6, but nevertheless predicts a "flood" of litigation in *Stratte-McClure*'s wake. But the Second Circuit's carefully reasoned opinion in *Stratte-McClure* shows the difficulty that plaintiffs will face if they base their claims on Item 303 omissions.

2. Further, The Materiality Standard Of Rule 10b-5 Is Higher Than That Of Item 303, So, Even Under The Second Circuit's Rule, Violations Of Item 303 Will Not Automatically Trigger 10b-5 Liability.

In addition to the need to prove scienter, not all omissions in violation of Item 303 will sufficiently state a "material omission" for purposes of Section 10(b). This Court has made clear that duty and materiality are distinct inquiries under Section 10(b), because whether there is a duty to disclose information at all differs significantly from whether omitted information is material to the decisions of investors. In *Basic*, the Court cautioned against "collaps[ing] the materiality requirement into the analysis of defendant's disclosure duties." 485 U.S. at 240 n.18. That is precisely what Petitioner asks the Court to do here, and the Court should – again – reject this suggestion.

This case shows the need for separating those inquiries. Although Item 303 itself creates a duty to disclose trends or uncertainties that the registrant "reasonably expects will have a material favorable or unfavorable impact," the SEC defines materiality differently for purposes of Item 303 than the Court has for Section 10(b). According to SEC guidance, Item 303 requires disclosure of certain information that is "reasonably likely to have a material effect" on the registrant's financial position or operations. SEC Release No. 34-26831, 1989 WL 1092885, at *6 n.27. The Commission has specifically disclaimed the materiality standard adopted by the Court in *Basic*, calling it "inapposite to Item 303 disclosure." *Id.* Item 303 thus has a lower threshold for

disclosure than Rule 10b-5's materiality standard, and therefore, not every unlawful omission in violation of Item 303 will meet Rule 10b-5's higher standard for materiality.

Decisions in the lower courts have acknowledged the lower materiality standard under Item 303. The *Stratte-McClure* court recognized that the court must separately evaluate whether the omission "is material under *Basic*, and the other elements of Rule 10b-5 have been established." 776 F.3d at 103-04. The Third Circuit, noting that "the materiality standards for Rule 10b-5 and SK-303 differ significantly," concluded that "a violation of SK-303's reporting requirements does not *automatically* give rise to a *material* omission under Rule 10b-5." *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000) (Alito, J.) (emphasis added). Although Petitioner contends that *Oran* precluded any reliance on Item 303 to establish a material omission, the court merely stated that, because materiality must be shown separately, a violation of Item 303 does not "inevitably" or "automatically" constitute a violation of Rule 10b-5. *Id.*[4]

[4] The key error of the Ninth Circuit's opinion in *In re NVIDIA Corp. Securities Litig.*, 768 F.3d 1046 (9th Cir. 2014), was to collapse the analysis of duty and materiality. Citing the difference in materiality standards, the court noted (correctly) that "[m]anagement's duty to disclose under Item 303 is much broader than what is required under the standard pronounced in *Basic*," and that "Item 303 requires more than *Basic*." *Id.* at 1055. As a result, the court inferred (incorrectly) "that Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." *Id.* at 1056. The Ninth Circuit was correct that, because Item 303 applies a lower standard of materiality than Section 10(b), violations of the duty to disclose cannot *on their own* establish a material omission in violation of Section 10(b). But the Ninth Circuit overlooked the fact that

3. The Statistics Cited By The Petitioner Are Misleading.

Petitioner cites statistics reporting that "[a] record 270 securities class actions were filed in 2016," and claims that the Second Circuit has been "flooded" with Item 303 litigation since its decision in *Stratte-McClure*. Pet. Br. 47, 53. The report cited by Petitioner provides essential context for understanding these statements. Upon closer inspection, it becomes clear that the Second Circuit's decision in *Stratte-McClure* has not created a flood of litigation. Instead the Ninth Circuit, which has rejected *Stratte-McClure*, saw a larger increase in filings than the Second Circuit.

The record number of securities filings in 2016 had nothing to do with *Stratte-McClure* or an increase in claims citing Item 303's disclosure requirements. Rather, "[a] substantial increase in federal M&A [mergers and acquisition] filings drove the overall jump in filing activity." Cornerstone Research, *Securities Class Action Filings: 2016 Year in Review* at 2. These filings "more than quadrupled to 80 filings." *Id.* at 3. The report cited by Petitioner attributed that increase to the Delaware Court of Chancery's decision in *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016). That decision, which restricted the types of settlements that the Delaware court would approve in M&A litigation, "may have resulted in shifting of merger objection lawsuits from state to federal venues." *Securities Class Action Filings* at 3. It was this shift of litigation from state to federal court, apparently in response to a Delaware decision, that drove the

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this Court in *Basic* explicitly rejected collapsing the duty and materiality inquiries in this manner.

overall increase in federal securities filings; it had nothing to do with any issue of federal law.

Nor was the increase in filing activity concentrated in the Second Circuit, as one would expect if *Stratte-McClure* were responsible. Instead, "filings in the Ninth Circuit were the highest on record." *Id.* at 32.

Petitioner further notes that "13 of the 100 largest private § 10(b) settlements since enactment of the PSLRA . . . occurred in 2016, the largest number of record settlements in any year." Pet. Br. 53. This is technically true, but it omits information necessary to make the statement not misleading. *Cf.* 17 C.F.R. § 240.10b-5. Petitioner omits to tell the Court that only one of the top 10, two of the top 25, and three of the top 40 settlements occurred in 2016. By contrast, 2013 had five of the top 25, and eight of the top 40, settlements.[5] Thus, 2016 was hardly a banner year for securities settlements, and Petitioner's attempt to show otherwise is misleading.

Petitioner has stretched the available data to support its claim that courts have been inundated with securities filings as a result of *Stratte-McClure*. But the truth is more mundane, and the available data suggest only a modest increase in securities filings, concentrated in the Ninth Circuit, and driven by the shifting of merger objection lawsuits from state to federal court. Petitioner's use of the available data is selective and not accurate.

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[5] *See* Securities Class Action Services, *The Top 100 U.S. Settlements of All-Time*, https://www.issgovernance.com/library/top-100-us-settlements/.

4. If Liability Would Create A Flood Of Litigation, It Would Have Happened By Now.

Petitioner predicts a "flood" of "hindsight-driven litigation" if Item 303 violations are treated as actionable. Pet. Br. 47. But there is a long history of administrative decisions, case law, and commentators accepting liability for Item 303 omissions under Rule 10b-5. If allowing such claims would result in a flood of litigation, the courts should all be underwater by now.

Liability under Rule 10b-5 for Item 303 omissions dates back to at least 1987, when the SEC filed an *amicus* brief in *Basic v. Levinson*, stating unequivocally its view that "[d]isclosure is required [under Rule 10b-5] only in certain limited circumstances, such as . . . where regulations promulgated by the Commission require disclosure." *Basic v. Levinson*, No. 86-279, Br. of Securities and Exchange Comm'n as Amicus Curiae, 1987 WL 881068, at *7 (Apr. 30, 1987). In 1995, the SEC concluded in an administrative proceeding that "the failure to disclose information required in Management's Discussion and Analysis may also be material" and thereby establish that a company "violated Section 10(b) or the Exchange Act and Rule 10b-5." *In re Valley Sys., Inc.*, SEC Release No. 34-36227, 1995 WL 547801, at *4 (Sept. 14, 1995). Court decisions accepting liability for omissions under Item 303 date back at least to *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1294-95 (9th Cir. 1998), which concluded that, for claims under the 1933 Securities Act, violations of Item 303 could establish a claim. The Third Circuit's opinion in *Oran* followed in 2000, and appeared to accept that violations of Item 303's disclosure requirements, if

material, could prove a claim under Rule 10b-5. 226 F.3d at 288. In 2004, two commentators published an analysis of the case law addressing this issue and suggested that the better view was the Item 303 omissions were actionable under Rule 10b-5. Donald C. Langevoort and G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1680 (2004) ("[A] deliberate omission has the same potential to mislead [as an affirmative misrepresentation] – the reader of the disclosure sees that the issuer is responding to the disclosure obligation and is entitled to assume that the response is not only accurate but complete as well."). There is thus nothing "novel" about the Respondents' claims here.

Institutional investors have a strong interest in ensuring that violations of Item 303 can form the basis of valid claims under Section 10(b) and Rule 10b-5 if the plaintiff satisfies the other legal elements of those claims.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

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