No. 16-581

IN THE

Supreme Court of the United States

LEIDOS, INC.,

Petitioner,

v.

INDIANA PUBLIC RETIREMENT SYSTEM,
INDIANA STATE TEACHERS' RETIREMENT FUND, and
INDIANA PUBLIC EMPLOYEES' RETIREMENT FUND,

Respondents.

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

BRIEF FOR THE SOCIETY FOR CORPORATE GOVERNANCE AS *AMICUS CURIAE* SUPPORTING PETITIONER

Lewis J. Liman
Counsel of Record
Meredith E. Kotler
Pamela L. Marcogliese
Jared Gerber
CLEARY GOTTLIEB STEEN & HAMILTON LLP
One Liberty Plaza
New York, New York 10006
212-225-2000
lliman@cgsh.com

Darla C. Stuckey
Granville J. Martin
SOCIETY FOR CORPORATE GOVERNANCE
240 West 35th Street, Suite 400
New York, New York 10001
212-681-2000

Counsel for Amicus Curiae

June 28, 2017

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INTEREST OF *AMICUS CURIAE* [1]

Founded in 1946, the Society for Corporate Governance (the "Society") is a professional association of over 3400 governance professionals who serve 1600 public, private and not-for-profit companies of most every size and industry. Its members support the work of corporate boards and executive management regarding corporate governance and disclosure, compliance with corporate and securities laws and regulations, and stock-exchange listing requirements. The Society's mission is to shape corporate governance through education, collaboration and advocacy, with the ultimate goal of creating long-term shareholder value through better governance.

As an organization whose members are often responsible for preparing corporate disclosures at their companies, the Society is acutely interested in the Court's review of the Second Circuit's ruling below, which (if adopted by the Court) would drastically alter the way that corporate disclosures are drafted. Before the Second Circuit's holding that companies could face expansive and chilling liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ("Section 10(b)"), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2017) ("Rule 10b-5"),

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[1] All parties have consented to this filing in letters to the Clerk of the Court. No counsel for a party authored this brief in whole or in part, and no person other than *amicus*, its members, and its counsel has made a monetary contribution intended to fund the preparation or submission of this brief.

for allegedly omitting "trends" and "uncertainties" under Item 303 of Regulation S-K, 17 C.F.R. § 229.303 (2017) ("Item 303"), the primary consideration driving the content of company disclosure in the management's discussion and analysis ("MD&A") section was management's view of the company and its prospects, based on its expertise and understanding of the industry as a whole, as intended by the U.S. Securities and Exchange Commission (the "SEC"). The Second Circuit undermined that by permitting plaintiffs to pursue pure omission-based claims under Item 303 based on hindsight theories that second-guess management's judgment. Its ruling upends decades of practice by putting management in the position of having to draft the most difficult MD&A disclosures defensively, with an eye toward avoiding liability in the event of a stock drop, lest a plaintiff be able to formulate a theory, plausible in hindsight, that a related trend or uncertainty should have been disclosed earlier. To minimize this risk, management will be pressed to disclose otherwise isolated events, no matter how trivial, for fear that an enterprising lawyer would later try to string them together to allege a trend. Notably, this incentive would apply primarily to anything that is or may be negative, both confusing and distorting the information provided to investors. The end result will be disclosures that are less meaningful and informative to investors, and that may even be misleading because they fail to provide a true reflection of management's view of the company or to distinguish between those developments that management truly

believes represent a trend and those which are more marginal (or do not yet—and may never—represent a trend at all).

SUMMARY OF ARGUMENT

The Society agrees with Petitioner's arguments that the Second Circuit's expansion of private liability under Section 10(b) to cover allegedly omitted "trends" and "uncertainties" was erroneous under the text and structure of the federal securities laws, as well as the Court's frequent admonition that Section 10(b) and Rule 10b-5 "do not create an affirmative duty to disclose any and all material information" and companies can therefore "control what they have to disclose . . . by controlling what they say to the market." *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44-45 (2011) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988)). The Society submits this brief to describe, based on its members' extensive experience, the robust process for drafting corporate disclosures that developed in the many decades preceding the Second Circuit's recent ruling, and the significant changes to that process, with attendant negative consequences for companies and investors alike, were the Court to adopt the Second Circuit's ruling.

I. The SEC adopted the MD&A disclosure requirements in Item 303 in order to allow investors to "see the company through the eyes of management." MD&A of Financial Condition and Results of Operations, Securities Act Release No. 8350, 2003 WL 22996757, at *2 (Dec. 19, 2003). The

disclosure regime that predated the Second Circuit's ruling served that purpose. In the decades following the SEC's adoption of MD&A disclosure requirements, companies developed a disciplined process for drafting those disclosures. A company typically expends significant resources preparing its corporate disclosures and, with respect to MD&A in particular, calls upon its management to make difficult judgments concerning the information that should be disclosed about the company's business and prospects in order to allow investors to see the company through management's eyes. The SEC currently plays a critical oversight and enforcement role in the MD&A disclosure process, including by providing uniform guidance on the MD&A disclosure rules, engaging in a comment letter process, which functions both as a dialogue with individual companies and as an educational resource more generally, and pursuing enforcement actions for potential violations of the MD&A disclosure rules. This regime provides companies with clear guidance concerning MD&A disclosure requirements, and it allows MD&A to be drafted by management with the primary objective of informing investors of its view of the company.

II. The Second Circuit's ruling, which creates significant potential liability under Section 10(b) by allowing plaintiffs to use hindsight to second-guess management's judgments about developing trends, would lead to an unnecessary and counterproductive paradigm shift in the preparation of MD&A. Rather than permitting management to draft MD&A with

the primary goal of informing investors about its view of the business, companies would be incentivized to turn over drafting responsibility to litigation counsel and to over-disclose all potential "trends" and "uncertainties" lest what may not now be characterized as a trend based on management's judgment of currently available information is later judged to have become one based on hindsight. Similarly, the uniform guidance currently provided by the SEC would be swamped by a multitude of potentially conflicting interpretations of Item 303 issued in the numerous district courts across the country. This would increase the costs of compliance with Item 303 and make it more difficult for the SEC to provide clear, consistent guidance to companies, as it would have to contend with the various interpretations of Item 303 that would emerge. Adopting the Second Circuit's rule would therefore result in a more expensive MD&A disclosure process, while also leading to MD&A disclosure that is significantly less useful and informative than exists under the current disclosure regime.

III. Finally, these changes would run counter to Congress's recent efforts to reduce the burden of disclosure, not increase it, and to make disclosures more accessible to investors, not less. And the SEC has also indicated that it believes the scope of Item 303's disclosure requirements do not need expansion.

ARGUMENT

I. THE CURRENT DISCLOSURE REGIME RESULTS IN MD&A THAT FURTHERS THE SEC'S GOAL OF ALLOWING INVESTORS TO SEE THE COMPANY THROUGH THE EYES OF MANAGEMENT

The SEC has emphasized that MD&A is a "critical component" of disclosure in that it allows investors to "see the company through the eyes of management," and that trend disclosure in particular 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." Securities Act Release No. 8350, 2003 WL 22996757, at **1-2, 10. The SEC therefore has stated that it "has long sought through its rules, enforcement actions and interpretive processes to elicit MD&A that not only meets technical disclosure requirements but generally is informative and transparent." *Id.* at *1.

More generally, the SEC's stated goals for corporate disclosure emphasize that such disclosure should be "clear" and "informative" to investors, *id.*, and "must be both useful and understandable," MD&A of Financial Condition and Results of Operations, Securities Act Release No. 8056, 2002 WL 77153, at *3 (Jan. 22, 2002). The SEC has therefore instructed registrants that "management should provide the most relevant information and

provide it using language and formats that investors can be expected to understand." *Id.*

Developed over the decades preceding the Second Circuit's erroneous ruling, the MD&A disclosure regime served these goals by allowing companies, with expert guidance and oversight from the SEC, to make thoughtful disclosure of the trends and uncertainties that management considered important to an understanding of their business at the time of the disclosure, without the fear that any undisclosed facts that could plausibly be portrayed in retrospect as known trends would lead to potentially ruinous liability under Section 10(b).

A. Companies Currently Engage In A Disciplined Process That Results In Robust MD&A Disclosure

To comply with Item 303's requirement to disclose "known" "trends" and "uncertainties," companies must expend significant resources gathering information, drafting appropriate language and forecasting the future. "[T]he process of estimating the impact of those trends, events, and uncertainties . . . is a constant and continuing one." John C. Coffee et. al, *Securities Regulation* 205 (13th ed. 2015). This extensive and time-consuming undertaking requires the disciplined efforts of management and other employees at all levels of the company, as each SEC filing requires that innumerable details be evaluated, confirmed and updated.

1. While there is some variation across companies, employees typically begin drafting MD&A several weeks—and sometimes several months—in advance of the filing deadline. Generally, employees with legal and financial reporting specialties will begin drafting and soliciting input from others throughout the company, to accurately synthesize the required information. Senior executives provide critical insight, but companies must also engage a broad range of lower-level employees to ensure that those "best positioned to be cognizant of the trends and uncertainties" have identified specific concerns. Matthew E. Kaplan et al., Debevoise & Plimpton LLP, *Disclosure Considerations for the 2016 Annual Reporting Season* 2 (Jan. 20, 2016), http://www.debevoise.com/~/media/files/insights/publications/2016/01/20160120_disclosure_considerations_for_the_2016_annual_reporting_season.pdf. Companies have built elaborate systems of disclosure controls and procedures in order to ensure that relevant information is timely identified, captured and communicated to the drafters. As a backstop, these efforts are often accompanied by a complex system of certifications and sub-certifications that extends to the furthest reaches of the company, designed to confirm that all relevant disclosure has been made, and which ultimately includes certifications issued directly to the SEC by the CEO and CFO.

Further, a full review under Item 303 frequently obliges employees to supply information not only about their own operations, but also to provide

insight on "general economic and industry-wide factors" to the extent such information may bear on the future performance of the company. *See id.*

Once this information has been collected, typically a company's disclosure committee reviews the draft disclosure. Generally, the disclosure committee, which meets quarterly, is composed of representatives of all functions relevant to a company's reporting, and typically includes the General Counsel, the CFO, the Investor Relations Officer, the Controller, the Chief Internal Audit Executive and the Director of Financial Reporting, as well as representatives from various business units. Deloitte LLP & Soc'y of Corp. Secretaries & Governance Prof'ls, *2014 Board Practices Report* 47 (2014), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-2014-board-practices-report-final-9274051-12122014.pdf; Skadden, Arps, Slate, Meagher & Flom LLP, *SEC Issues Final Rules On CEO/CFO Certification Under Section 302 Of The Sarbanes-Oxley Act* 8 (Sept. 2002), https://files.skadden.com/sites%2Fdefault%2Ffiles%2Fpublications%2F841library.pdf. In addition, internal and external lawyers and accountants must review the initial trove of information in conjunction with the draft disclosure, and evaluate its importance. *See* Ernst & Young LLP, *Staying on Course: A Guide for Audit Committees* 1 (2014), http://www.ey.com/Publication/vwLUAssets/A_guide_for_audit_committees/$FILE/EY-Staying-on-course-guide-for-audit-committees.pdf. Finally, depending on the company's specific procedures, the company's

audit committee, the full board and officers will review and approve the disclosure prior to filing.

2. Amid these many layers of input and review, there is extensive discussion about the type and degree of disclosure. Close calls, including with respect to materiality and whether a series of events constitutes a "trend," can monopolize the attention of company management for days at a time and may require the assistance of outside counsel—particularly where the decisions risk exposing the company to litigation and significant liability.

The most difficult decisions will often center on whether an issue is ripe for disclosure: whether there is truly a problem, and whether enough is known about the problem to make disclosure useful to investors. *See* Gus P. Coldebella & Caroline K. Simmons, *Where Cybersecurity Meets Corporate Securities: The SEC's Push to Regulate Public Companies' Cyber Defenses and Disclosures*, *in* Palo Alto Networks Inc. & N.Y. Stock Exch., *Navigating the Digital Age: The Definitive Cybersecurity Guide for Directors and Officers* 57, 63 (Matt Rosenquist ed., 2015), https://www.nyse.com/publicdocs/Navigating_The_Digital_Age.pdf ("The decision to disclose is only half of the . . . equation—another question is, when?"). Managing these complexities requires exceptionally fine-tuned judgment and industry savvy. In the most difficult cases, the company lacks all of the information it needs to make a conclusive and comprehensive disclosure to the market, but it has enough information to know

that at some point, disclosure may need to be made depending on how events unfold.

For example, when a company first learns that it has suffered a cyber-attack, it may not immediately know the quantity or type of data that has been breached, complicating the decision about what, and when, to disclose. *See id.* at 63 ("In a typical [cyber] breach, however, it is rare for an entity to be able to immediately assess the attack's scope—investigations take time. . . . Generally, companies should resist falling into the immediate disclosure trap, because in our experience a cyber incident looks very different at the end of the first week than it does at the end of the first day."); *see also* Ernst & Young LLP, *Investigating a Data Breach* 2 (2014), http://www.ey.com/Publication/vwLUAssets/IT_Forensic_Services_-_Investigating_a_data_breach/$FILE/EY-IT-Forensic-Services-Investigating-a-data-breach.pdf (explaining that uncovering the extent of the information breached "can be the most critical and difficult question to answer"). Under such circumstances, companies must tread with extreme caution to avoid acting prematurely and inadvertently giving investors misinformation or disclosing as a trend something that is not and may never be a trend, while at the same time not delaying so long that they can be said to be concealing a problem. Prior to the Second Circuit's ruling, companies could make these decisions based on their considered business judgment, without being influenced by the specter of significant private liability under Section 10(b).

Furthermore, SEC filings are but a part of the information conveyed to investors on an ongoing basis. Earnings releases provide additional insight to investors, and company officers spend meaningful time discussing their business with sophisticated investors and industry analysts, both in group settings such as calls and conferences, as well as on an individual basis. The result of such close interaction with investors is that investors are able seek a broad range of information and probe into many aspects of the business.

B. The SEC Currently Plays A Central Oversight And Enforcement Role With Respect To MD&A Disclosure

Under the MD&A disclosure regime that predated the Second Circuit's ruling, the SEC played a key role throughout the disclosure process: preparing guidance and interpretive releases that companies could rely upon in drafting MD&A, reviewing and commenting on disclosures, and enforcing any perceived violations of the disclosure rules. The SEC's central role in the disclosure regime provided companies with uniform guidance in drafting MD&A disclosures and provided a mechanism for enforcement of the disclosure rules, all of which furthered the purpose of providing investors with clear and meaningful disclosure.

1. In drafting MD&A disclosures, companies rely upon the expert guidance provided by the SEC's Division of Corporation Finance ("DCF"), including through Staff Legal and Accounting Bulletins, Staff

Disclosure Guidance Topics, updates to the Division's Financial Reporting Manual, no-action and interpretive letters and Compliance and Disclosure Interpretations. With respect to MD&A disclosures in particular, the DCF has issued extensive guidance. *See, e.g.*, Securities Act Release No. 8350, 2003 WL 22996757; MD&A of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835, 1989 WL 1092885 (May 18, 1989).

The DCF's staff, which possesses "specialized industry, accounting, and disclosure expertise," also reviews disclosure filings and actively discusses these disclosures with the filing companies. *Division of Corporation Finance: Filing Review Process*, SEC (Jan. 19, 2017), https://www.sec.gov/divisions/corpfin/cffilingreview.htm. The DCF's staff reviews each reporting company to at least some extent every three years. *Id.* "When the [DCF's] staff identifies instances where it believes a company can improve its disclosure or enhance its compliance with the applicable disclosure requirements, it provides the company with comments." *Id.* The company and the staff then engage in a dialogue consisting of the exchange of letters or more informal discussions, which allows the company to either explain its disclosures to the staff's satisfaction or amend its disclosures to address the staff's comments. *Id.* (noting that the "[DCF's] staff members, at all levels, are available to discuss disclosure . . . with a company and its legal, accounting, and other advisors"). The SEC routinely comments on

companies' MD&A disclosures in particular. *See, e.g.*, Photronics, Inc., SEC Staff Comment Letter (Mar. 13, 2017); ADTRAN, Inc., SEC Staff Comment Letter (Aug. 24, 2016); Eagle Materials Inc., SEC Staff Comment Letter (Feb. 22, 2016).

The SEC also has taken enforcement actions against companies where it has concluded that there have been violations of Item 303. *See, e.g.*, *Kirchner*, Exchange Act Release No. 80947, 2017 WL 2591798 (June 15, 2017); *Bank of Am. Corp.*, Exchange Act Release No. 72888, 2014 WL 4101590 (Aug. 21, 2014); *Tidewater Inc.*, Exchange Act Release No. 56557, 2007 WL 2803999 (Sept. 27, 2007); *Raytheon Co.*, Securities Act Release No. 8715, 2006 WL 1788543 (June 28, 2006); *Salant Corp.*, Exchange Act Release No. 34046, 1994 WL 183411 (May 12, 1994); *SEC v. Melchior*, No. 90–C–1024J, 1993 WL 89141 (D. Utah Jan. 14, 1993); *Caterpillar Inc.*, Exchange Act Release No. 30532, 1992 WL 71907 (Mar. 31, 1992).

Finally, the SEC periodically reevaluates its enforcement of the securities laws and has specifically evaluated and re-evaluated the MD&A requirements in Item 303. Consistently, the SEC has expressed satisfaction with Item 303 requirements. As early as 1989, it observed that "the Commission concurs with the view expressed by most commentators that no amendments to the MD&A requirements set forth in Regulation S-K are needed at this time." Securities Act Release No. 6835, 1989 WL 1092885, at *2. More recently, as required by

Congress in the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012), the SEC undertook a "review of Regulation S-K to determine how such requirements can be updated to modernize and simplify the registration process." SEC, *Report on Review of Disclosure Requirements in Regulation S-K* 1 (Dec. 2013), https://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf. As described in the resulting report, the SEC then commenced the so-called Disclosure Effectiveness Initiative, "a comprehensive evaluation of the information [its] rules require registrants to disclose" to evaluate, in part, "whether existing disclosure requirements should be modified or eliminated." SEC, *Report on Modernization and Simplification of Regulation S-K* 1 (Nov. 23, 2016), https://www.sec.gov/files/sec-fast-act-report-2016.pdf. The SEC has considered nearly 200 pages of proposed amendments to Regulation S-K, including five that touched on Item 303. *See id.* at 9-11; Business and Financial Disclosure Required by Regulation S-K, Securities Act Release No. 10064, 2016 WL 1595258, *23941-54 (Apr. 13, 2016). While the project remains ongoing, the SEC has thus far not indicated an interest in modifying Item 303's trend and uncertainty disclosure requirements, nor suggested any concern about Item 303 compliance. SEC, *Report on Modernization and Simplification of Regulation S-K*, *supra*, at 9-11.

2. There are good reasons why Congress entrusted the SEC, rather than private plaintiffs, with primary responsibility for the interpretation

and enforcement of Item 303. As an initial matter, doing so ensures that the securities laws are interpreted and enforced consistently across the country. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188-89 (1994) (explaining the need for predictability in the securities markets). It also ensures that the securities laws are enforced according to the SEC guidance discussed above. Additionally, the SEC is able to provide prospective alterations to the disclosure regime, whereas civil litigation is inherently retrospective.

More fundamentally, however, because the SEC's mission is to protect investors broadly, it is best positioned to consider the impact of its interpretive and enforcement decisions in a larger societal and market context. Plaintiffs' lawyers have an ethical obligation to maximize recovery for their clients, regardless of the general public policy effect of the legal position they are taking. *See* Model Rules of Prof'l Conduct r.1.3 cmt. (Am. Bar Ass'n 2016). The SEC, by contrast, takes all of its actions "with an eye toward promoting the capital formation that is necessary to sustain economic growth" and benefit the market and economy as a whole. *What We Do*, SEC (June 10, 2013), https://www.sec.gov/Article/whatwedo.html. The SEC is therefore uniquely able to weigh and determine how to promote a proper balance between over- and under-disclosure, as well as between premature and tardy disclosure. And, unlike private litigants, the SEC is able to balance the need for appropriate enforcement against the

negative consequences that can result from over-enforcement. *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship*, 108 Colum. L. Rev. 1301, 1329 (2008) (explaining that "[i]f overdeterrence appears to be a problem . . . the public enforcer can adjust by ratcheting down the enforcement level; conversely, if underdeterrence appears to be a problem, the public enforcer can ratchet it up").

Moreover, the need to consider the societal impacts of enforcement is particularly important for generally worded regulations like Item 303 that, if always enforced to the greatest extent, could result in undesirable consequences. *Id.* ("Discretionary nonenforcement allows society to avoid the costs of crafting more precisely tailored rules, and the loopholes such rules inevitably create."); *see also* Securities Act Release No. 6835, 1989 WL 1092885, at *1 (MD&A requirements "are intentionally general, reflecting the Commission's view that a flexible approach elicits more meaningful disclosure and avoids boilerplate discussions"). Private plaintiffs, and their lawyers, do not have the same mission and are not equally well-positioned to promote the SEC's mission through selective enforcement decision-making.

II. THE SECOND CIRCUIT'S RULE WOULD DRAMATICALLY ALTER THE PROCESS FOR DRAFTING DISCLOSURE, DEGRADE THE QUALITY OF DISCLOSURE AND HARM INVESTORS

If adopted by the Court, the Second Circuit's expansion of Section 10(b) liability to the alleged omissions of "trends" and "uncertainties" in MD&A would lead to a paradigm shift in the preparation and enforcement of such disclosure. The potential consequences of this shift would be pronounced—disclosures would be less useful to investors, but more expensive for companies to prepare. In addition, the shift would frustrate the recently considered judgments of Congress and the SEC in this area.

A. The Second Circuit's Ruling Will Change The Disclosure Process And Lead To Disclosures That Are Less Useful To Investors

The specter of expansive liability and costly litigation under Section 10(b) created by the Second Circuit's ruling will incentivize companies to dramatically change their MD&A disclosure processes and practices, which will lead to significantly less useful disclosures, to the detriment of the investing public and registrants alike.

1. Determining what constitutes a "trend," and whether a "trend" or "uncertainty" is "reasonably likely" to be material, necessarily involves making

difficult judgments in the face of considerable ambiguity and uncertainty. It requires management to forecast the future based upon imperfect or incomplete information. Trends are notoriously difficult to identify, both *ex ante* and in hindsight.[2] The SEC itself has acknowledged how difficult trends and their future impacts are to judge, stating that "even the most carefully prepared and thoroughly documented projections may prove inaccurate." Safe Harbor Rule for Projections, 44 Fed. Reg. 38810 (July 2, 1979).

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[2] *Cf.* A. C. Grayling, *How We Form Beliefs*, 474 Nature 446, 446 (2011) (explaining "patternicity," the brain's propensity to seek patterns, which "leads us to see significance in mere 'noise' as well as in meaningful data"); Hartmut Blank et al., *Hindsight Bias: On Being Wise After the Event*, 25 Soc. Cognition 1, 2-4 (2007) (explaining the tendency to fall victim to hindsight bias); Muntazir Hussain et al., *Hindsight Bias and Investment Decisions Making Empirical Evidence Form an Emerging Financial Market*, 2 Int'l J. Res. Stud. Mgmt. 77, 80 (2013) (research indicates that hindsight bias is present "not . . . only in [an] unconscious way . . . but also when [the] subject is aware of the bias"); Stephen J. Hoch & George F. Loewenstein, *Outcome Feedback: Hindsight and Information*, 15 J. Experimental Psychol.: Learning, Memory, & Cognition 605 (1989) (noting that hindsight bias is frequently greater with respect to difficult decisions); Baruch Fischhoff, *Perceived Informativeness of Facts*, 3 J. Experimental Psychol.: Hum. Perception & Performance 349, 355 (1977) ("[T]he effect seems greatest for the most surprising answers."); David A. Schkade & Lynda M. Kilbourne, *Expectation-Outcome Consistency and Hindsight Bias*, 49 Organizational Behav. & Hum. Decision Processes 105, 118 (1991) ("Bias is significantly larger when subjects were surprised by the outcome . . . .").

Under the Second Circuit's ruling, companies seeking to avoid the prospect of costly litigation will be incentivized to resolve all unclear disclosure decisions in favor of more disclosure, leading to disclosure of marginal, insignificant and potentially misleading information. This is all the more likely in light of the double negative inquiry required by Item 303: if management *cannot* conclude that a trend is unlikely to materialize, then it must disclose *unless* management determines that the trend would be immaterial. Securities Act Release No. 6835, 1989 WL 1092885, at *6.

For example, assume that a company has received an internal complaint from an anonymous whistleblower. When a whistleblower complaint is received, a company must first evaluate the complaint from a number of angles before deciding whether it merits disclosure to investors—considering the plausibility of the allegations, as well as the potential impact on the business should those allegations turn out to be true. Following an initial evaluation, management might engage an external firm to conduct an independent investigation into the allegations, or conduct its own investigation. At some point, management may satisfy itself that the course of the investigation qualifies as a trend or uncertainty requiring disclosure, and decide to disclose the issue to the market. (Management might also decide that the allegations are not justified, or are isolated and do not represent a disclosable trend.) This takes time. But the point at which management decides to disclose the issue will always

be subject to second-guessing. If management must fear that its decision will be questioned in hindsight by private litigants, management will be pushed to err on the side of disclosing too much information too soon, before it is confident in the results of the investigation.

And premature disclosure carries its own risks. The disclosure of the fact of the investigation could cause investors to believe that the company is in greater danger than it truly is, causing an artificial and unfounded drop in a company's share price to the detriment of all investors. Premature disclosure is also more likely to be incomplete or partially inaccurate, putting companies in a Catch-22: either they wait to disclose until they are more certain and risk being sued on the theory that they waited too long, or they disclose prematurely and risk having to later correct the incomplete, early disclosure, creating the potential for a lawsuit alleging that their first disclosure was misleading. Placing companies in such a double bind serves no useful purpose.

This incentive to over-disclose or prematurely disclose events that may not be and may never become trends will be powerful, given the *in terrorem* effect of Section 10(b) litigation. Companies that manufacture or sell consumer goods will need to consider whether every product return or warranty claim could be plausibly viewed in hindsight as an emerging trend that requires disclosure. Pharmaceutical companies will need to weigh

whether every adverse drug reaction or device failure reported by an individual subsequently could be viewed in hindsight by a private litigant as an early trend that should have been disclosed. Food services companies will need to consider whether initial negative feedback in response to the rollout of a new menu, which management did not think did or would constitute a trend, nonetheless would be characterized by an entrepreneurial plaintiff's lawyers as the onset of a disclosable material trend should the worst unexpectedly happen.[3]

The result of the incentives created by the Second Circuit's ruling thus will be not only more disclosure, but also disclosure of lower quality—the "avalanche of trivial information" that the Court warned of in

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[3] Recent complaints filed in federal district courts provide a flavor of the sorts of hindsight-bias claims companies are facing and are likely to continue to face under the Second Circuit's rule. *See, e.g.*, Compl. for Violations of the Federal Securities Laws, *City of Warwick Mun. Emps. Pension Fund v. Rackspace Hosting, Inc.*, No. 17-CV-3501 (JFK) (S.D.N.Y. May 10, 2017), ECF No. 1 (Section 10(b) claim based, in part, on alleged failure to disclose under Item 303 ongoing negotiations about renewal of a customer contract); Corrected Am. Class Action Compl., *Jackson v. Halyard Health, Inc.*, No. 16-CV-5093-LTS-RLE (S.D.N.Y. Dec. 12, 2016), ECF No. 50 (Section 10(b) claim based, in part, on alleged failure to disclose under Item 303 that a company's surgical gowns were possibly deficient as reported by competitor studies and press reports); Consolidated Am. Compl. for Violations of the Federal Securities Laws, *In re Target Corp. Sec. Litig.*, No. 16-1315 (JNE/BRT) (D. Minn. Nov. 14, 2016), ECF No. 57 (Section 10(b) claim based, in part, on alleged failure to disclose under Item 303 ongoing challenges with a company's supply chain information technology systems).

Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). This dynamic would harm investors and contradict the SEC's ongoing efforts to make corporate disclosures more useful to investors.

a. The increased disclosure of items of dubious significance under the Second Circuit's ruling will not be helpful to investors, both because those items will themselves not be illuminating, and because their inclusion in already voluminous disclosures will make it harder for investors to identify and distinguish the most critical information from that which is disclosed to avoid the risk of potential future liability. In 2013, the average length of public companies' annual SEC filings on Form 10-K was already almost 42,000 words, nearly 3 times the length permitted for a merits brief in this Court (15,000 words) and significantly longer than a short novel like George Orwell's 30,000-word *Animal Farm*. *See* Vipal Monga & Emily Chasan, *The 109,894-Word Annual Report*, Wall St. J., June 2, 2015, https://blogs.wsj.com/cfo/2015/06/02/the-109894-word-annual-report/. Under the Second Circuit's rule, disclosures are likely to only get longer. The SEC has recognized the "possibility that high levels of immaterial disclosure can obscure important information or reduce incentives for certain market participants to trade or create markets for securities." Securities Act Release No. 10064, 2016 WL 1595258, at *23919. Investors faced with an ever larger flood of "trend" disclosure will struggle to separate the trends that management actually considers important from more marginal sets of

similar events that were included primarily to reduce the prospects of future liability.

The additional and premature disclosure may also be actually inaccurate and misleading to investors, including because the Second Circuit's ruling will incentivize companies to over-disclose potentially negative information in order to avoid potential omission liability (with no countervailing incentive to increase disclosure of potentially positive information). As a result of these incentives, the market may form unnecessarily negative views about a company's prospects, which could artificially depress its stock or otherwise cause investors to mistakenly undervalue the company.

b. In line with the Court's admonition about over-disclosure in *Basic Inc.*, the SEC has stated that "the effectiveness of MD&A decreases with the accumulation of unnecessary detail," and emphasized that "companies should avoid the unnecessary information overload for investors that can result from disclosure of information that is not required, is immaterial, and does not promote understanding." Securities Act Release No. 8350, 2003 WL 22996757, at **3, 9. The SEC therefore has stated "it is increasingly important for companies to focus their MD&A on material information" and has encouraged companies to "evaluate issues presented in previous periods and consider reducing or omitting discussion of those that may no longer be material or helpful." *Id.* at *9.

The SEC also noted in an adopting release that a higher threshold for trend disclosure would reduce the possibility that investors will be "overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information" under a lower disclosure threshold. Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 8182, 2003 WL 236157, *5985 (Jan. 28, 2003). And the recently departed SEC Chair Mary Jo White likewise has spoken about the problem of "information overload" in which "ever-increasing amounts of disclosure make it difficult for investors to focus on the information that is material and most relevant to their decision-making . . . ."[4]

Because of the *in terrorem* impact of the Second Circuit's expansion of Section 10(b) liability to Item 303, however, companies will be incentivized to lower their disclosure threshold for potential trends, which will undermine the above-articulated SEC goals.

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[4] Mary Jo White, Chair, SEC, *The Importance of Independence*, The Fourteenth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities, and Financial Law at the Fordham Corporate Law Center (Oct. 3, 2013), *in* 20 Fordham J. Corp. & Fin. L. 1, 13 (2014) (also noting that "the SEC needs to maintain the ability to exercise its own independent judgment and expertise when deciding whether and how best to impose new disclosure requirements. For, it is the SEC that is best able to shape disclosure rules consistent with the federal securities laws and its core mission").

2. The incentives created by the Second Circuit's ruling will also change the way that MD&A disclosures are drafted, to the detriment of investors.

Because the purpose of MD&A disclosure is to allow investors to "see the company through the eyes of management," the SEC has stated that "MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business." Securities Act Release No. 8350, 2003 WL 22996757, at *2. The SEC therefore has observed that "[m]anagement has a unique perspective on its business that only it can present." *Id.* The Second Circuit's ruling threatens to deprive investors of this unique perspective.

Rather than permitting management to draft MD&A with the primary goal of allowing investors to see the company through the eyes of management, the Second Circuit's ruling would incentivize companies to turn over drafting responsibility to litigation counsel with the objective of addressing how a company could potentially be viewed with hindsight if the worst should happen in every instance. But determining what constitutes a "trend" can require a sophisticated understanding of a company's business to determine what implications a particular set of facts might have—an understanding that experienced management is well-positioned to possess, but litigators are not.

As a result, the MD&A disclosure caused by the Second Circuit's ruling may itself be misleading to investors, since it will lead to the over-disclosure of

marginal trends that management does not consider significant, but were included to reduce the risk of future liability. The Second Circuit's ruling will thus deprive investors of the ability to see the company through the eyes of management.

B. The Second Circuit's Expansion Of Liability Would Also Increase The Costs Of Being A Public Company

In addition to degrading the quality of MD&A disclosure, the Second Circuit's ruling will also increase the costs of preparing that disclosure. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 164 (2008) (considering the impact that expanding liability under Section 10(b) would have on the cost of being a public company).

1. As discussed above, the process of drafting MD&A already is labor-intensive and challenging. That process will only become more time-consuming and expensive under the Second Circuit's ruling.

a. In response to the Second Circuit's ruling, companies may be forced to change their structure of internal controls to ensure that everything that could conceivably be considered a trend in retrospect is reported up to management for evaluation. Companies thus may be required to involve even more employees located in further reaches of the company in the disclosure process. Management would also be required to sift through vast amounts of data to identify all sets of potentially related

events that a future plaintiff might try to string together into a trend after a stock price drop.

b. Undermining the primacy of the SEC in providing consistent interpretation and guidance on MD&A disclosure rules, and introducing a multiplicity of diverse views and conclusions from private litigants and disparate courts, will make it more difficult for companies to correctly determine what to disclose. Under the Second Circuit's ruling, companies will therefore need to take on the additional expense and burden of regularly reassessing the legal landscape concerning trend disclosure and incorporating into their disclosure decision-making an updated overview of all legal theories and pronouncements in this area.

c. Moreover, the over-disclosure encouraged by the Second Circuit's ruling can carry increased costs and liability risks for companies that extend well beyond the disclosure- and securities-litigation context—e.g., potentially requiring unnecessary disclosure of commercially sensitive information—and that can be difficult to foresee.

2. In addition, the increased disclosure costs associated with the Second Circuit's ruling would undermine the SEC's efforts to "appropriately balance the costs of disclosure with the benefits" of disclosure. Securities Act Release No. 10064, 2016 WL 1595258, at *23917.

In particular, the SEC has expressed interest in "lower[ing] the cost to registrants of providing

information to investors," *id.*, and has further acknowledged that:

> Disclosure can be costly for registrants to produce and disseminate, and disclosure of certain sensitive information can result in competitive disadvantages. There is also a possibility that high levels of immaterial disclosure can obscure important information or reduce incentives for certain market participants to trade or create markets for securities. The appropriate choice of disclosure requirements therefore involves certain tradeoffs.

Id. at *23919. Likewise, "courts have been sensitive about forcing a company to damage its own interests as well as those of its shareholders by revealing competitive information." *Ventry v. Sands* (*In re Canandaigua Sec. Litig.*), 944 F. Supp. 1202, 1211 (S.D.N.Y. 1996) (citing *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 809 (2d. Cir. 1996)).

The increased costs of the Second Circuit's ruling will undermine these efforts.

III. THE SECOND CIRCUIT'S RULING DISREGARDS CONGRESS'S AND THE SEC'S CONSIDERED JUDGMENTS ABOUT MD&A DISCLOSURE

The Second Circuit's extension of Section 10(b) liability to trend and uncertainty disclosure under Item 303 also threatens to upset the careful judgments made by Congress and the SEC with respect to the scope of MD&A disclosure.

1. Increasing the burden of disclosure would run counter to recent congressional efforts to reduce it. In 2015, Congress enacted the Fixing America's Surface Transportation Act, Pub. L. No. 114-94, 129 Stat. 1312 (2015) (the "FAST Act"). Although primarily a transportation and infrastructure law, the FAST Act included sections aimed at modernizing and simplifying Regulation S-K's disclosure requirements. In particular, Section 72002(2) of the FAST Act instructed the SEC to "eliminate provisions of regulation S-K, required for all issuers, that are duplicative, overlapping, outdated, or unnecessary." Section 72003 further required the SEC to perform a study to, among other things, "determine how best to modernize and simplify [the requirements of Regulation S-K] in a manner that reduces the costs and burdens on issuers while still providing all material information."

In enacting the FAST Act, Congress underlined the importance of reducing the burden of disclosing unnecessary and unhelpful information so that companies can instead focus their efforts and

resources on innovating and creating jobs. *See* H.R. Rep. No. 114-279, at 2 (2015) ("Simplifying and streamlining disclosure requirements will enable companies to divert fewer resources to compliance, freeing up additional capital for other purposes."). Congress also stated that it believes company management should be given the discretion to determine what information is important for investors to know. *See* H.R. Rep. No. 113-642, at 5 (2014) (explaining that one of the goals of the FAST Act was to "restore[] management discretion in identifying the material matters that should be disclosed to shareholders in periodic SEC filings"). A construction of Section 10(b) that increases the disclosure burdens under Item 303 would directly conflict with Congress's objectives to streamline these disclosure requirements.

2. Moreover, in response to this congressional action, the SEC recently initiated a disclosure effectiveness initiative in order to "facilitate the disclosure of information to investors, while simplifying compliance efforts, without significantly altering the total mix of information provided to investors." Disclosure Update and Simplification, Securities Act Release No. 10110, 2016 WL 4126005, *51608 (July 13, 2016). This initiative included a comprehensive review of disclosure requirements, public comments, proposed rulemaking and formal reports. By the numbers, the SEC released 1062 pages describing the initiative, 186 of which were devoted to proposed amendments. Eight hundred and two comments were submitted in response. After

careful review and engagement with multiple constituencies, and despite having determined that other regulations needed changes, the SEC thus far has not found a need to revise Item 303's trend disclosure requirements. SEC, *Report on Modernization and Simplification of Regulation S-K*, 9-11 (Nov. 23, 2016), https://www.sec.gov/files/sec-fast-act-report-2016.pdf.

The Second Circuit's expansion of liability under Item 303 thus threatens to upset the balance struck by Congress and the SEC, despite their recent reaffirmation that the scope of Item 303 does not need to be adjusted.

CONCLUSION

For the foregoing reasons, the Society urges the Court to reverse the decision of the Circuit Court.

Respectfully submitted,

Lewis J. Liman
Counsel of Record
Meredith E. Kotler
Pamela L. Marcogliese
Jared Gerber
CLEARY GOTTLIEB STEEN & HAMILTON LLP
One Liberty Plaza
New York, New York 10006
(212) 225-2000
lliman@cgsh.com

Darla C. Stuckey
Granville J. Martin
SOCIETY FOR CORPORATE GOVERNANCE
240 West 35th Street
Suite 400
New York, New York 10001

Counsel for Amicus Curiae

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