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 OF WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Under § 10(b) of the Securities Exchange Act of 1934 and its accompanying Rule 10b–5, an omission may be actionable only if the omitted information is necessary to make an affirmative statement "not misleading."

Thus, "companies can control what they have to disclose under these provisions by controlling what they say to the market." *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 45 (2011). In the decision below, however, the Second Circuit held that private plaintiffs can sue a company for omitting from a public filing information allegedly required by Item 303 of Regulation S-K – one of thousands of disclosure requirements in regulations promulgated by the Securities and Exchange Commission – even if the alleged omission did not make any affirmative statement in the filing misleading.

The question presented is:

Whether Item 303 of SEC Regulation S-K creates a duty to disclose that is privately enforceable under § 10(b) of the Securities Exchange Act and SEC Rule 10b–5.

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INTEREST OF *AMICUS CURIAE*[1]

Washington Legal Foundation (WLF) is a non-profit, public-interest law firm and policy center with supporters in all 50 States. Founded nearly 40 years ago, WLF devotes a substantial portion of its resources to advocating for free-market principles, individual and business civil liberties, limited government, and the rule of law.

To that end, WLF has regularly appeared before this and other federal courts in cases raising issues related to the proper scope of the federal securities laws. *See, e.g.*, Brief of Washington Legal Foundation as *Amicus Curiae* in Support of Respondents, *California Public Employees' Retirement System v. ANZ Securities, Inc.*, ___ S. Ct. ____ (2017) (No. 16-373); Brief of Washington Legal Foundation as *Amicus Curiae* in Support of Petitioner, *Kokesh v. Securities and Exchange Commission*, ___ S. Ct. ____ (2017) (No. 16-529); Brief of Washington Legal Foundation as *Amicus Curiae* in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014) (No. 13-

[1] Pursuant to Rule 37.6 of the Rules of this Court, the undersigned hereby state that no counsel for Petitioner or Respondents authored any part of this brief, and no person other than *amicus curiae* or its counsel made any monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.3(a) of the Rules of this Court, letters of consent from all parties to the filing of this brief are on file or have been submitted to the Clerk of the Court.

317). Likewise, WLF's Legal Studies Division has frequently published articles relating to the interpretation of the federal securities laws and related topics.

WLF is filing this brief to promote the interests of investors seeking useful information about companies for potential investment purposes and shareholders who suffer when the companies in which they own shares face outsized and unwarranted liability for statements they have made about the company's financial situation. WLF has no direct interest, financial or otherwise, in the outcome of this lawsuit. Because of its lack of direct interest, WLF believes it can assist the Court by providing a perspective distinct from that of any party.

SUMMARY OF ARGUMENT

Respondents advocate a broad expansion of the duty to disclose premised on the Second Circuit's flawed interpretation of Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") and Securities Exchange Commission ("SEC") Rule 10b-5 promulgated thereunder ("Rule 10b-5"). This expansion is at odds with the plain meaning of Rule 10b-5(b), the common-law fraud principles that guide this Court's interpretation of Section 10(b), and established Section 10(b) jurisprudence. Moreover, Respondents' position poses significant public policy concerns – principally, it would create an unwarranted litigation burden on companies and the courts.

First, the Second Circuit misapplies Rule 10b-5(b) – and the common-law principles of "half-truth" fraud that are reflected in it – to reach its holding in *Stratte-McClure v. Morgan Stanley* that "a failure to make a required Item 303 disclosure" that is material is "an omission that can serve as the basis for" a violation of Section 10(b) and Rule 10b-5. 776 F.3d 94, 100-01 (2d Cir. 2015). Rule 10b-5(b) provides that an omission can be actionable where it makes an affirmative statement misleading. Accordingly, this rule does not, and cannot, support a finding that failure to make disclosures of uncertainties and trends pursuant to SEC Regulation S-K, Item 303 ("Item 303") creates a duty to disclose where there is no specific, identified statement that is alleged to be misleading as a result of the omission. Indeed, notwithstanding the Second Circuit's reference to Rule 10b-5(b), it appears clear that the Second Circuit believes that Respondents should be able to bring their claim based on a pure omission theory.

Second, even if viewed as a pure omission claim, Respondents do not satisfy the requirements of a viable fraud-by-omission claim under traditional common-law fraud principles, or the Court's established jurisprudence regarding actionable omissions under Section 10(b) and SEC Rule 10b-5(a) and (c). Consistent with the applicable common-law principles, which are reflected in the Restatement of Torts (Second) Section 551, the Court has only ever recognized an actionable fraudulent omission where at least two separate conditions are met: the existence of (a) a fiduciary relationship, and (b) a transaction to which the

defendant was a party and in which he participated for personal gain. Neither condition is satisfied, let alone both, by an issuer's mere omission, in its periodic financial disclosures, of information that is the subject of Item 303.

Finally, there are significant public policy implications to the Court's adopting the Second Circuit's holding. The Supreme Court routinely considers public policy when evaluating the contours of the Section 10(b) and Rule 10b-5 private right of action. Here, there can be no doubt that the Second Circuit's holding benefits no one but the plaintiffs' bar. The Second Circuit's holding will lead to a deluge of unnecessary corporate disclosures, which the SEC has discouraged and recognized are unhelpful for shareholders. It also will lead to increased and protracted securities-fraud litigation which will harm companies and deplete already strained judicial resources.

In sum, the Second Circuit's flawed reasoning leads to the wrong result. Under established Supreme Court precedent, failing to comply with Item 303 may not be an independent basis for Section 10(b) or Rule 10b-5 liability. Ruling otherwise would greatly expand the implied private right of action beyond anything contemplated by Congress or the courts. Such a holding would have an adverse impact on shareholders, companies, and the courts.

ARGUMENT

I. THE SECOND CIRCUIT'S HOLDING MISAPPLIES SEC RULE 10b-5(b) AND THE COMMON-LAW PRINCIPLES OF HALF-TRUTH FRAUD THAT ARE REFLECTED IN IT

The Second Circuit held that omitting statements that an issuer is purportedly required to disclose under Item 303 can give rise to liability under Section 10(b) and Rule 10b-5(b), so long as the other elements of a federal securities fraud claim have been established. *Indiana Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85 (2d Cir. 2016). In relevant part, Item 303 requires corporate management to "[d]escribe [in 10-K and 10-Q forms] any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii).[2]

In so holding, the Second Circuit applied its ruling in *Stratte-McClure v. Morgan Stanley* that "a failure to make a required Item 303 disclosure" is "an omission that can serve as the basis for" a

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[2]*See also* Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, Exchange Act Release No. 26,831, 43 SEC Docket 1330 (May 18, 1989) ("disclosure [under Item 303] is necessary 'where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial conditions or results of operation'").

violation of Section 10(b) and Rule 10b-5. 776 F.3d 94, 100-01 (2d Cir. 2015). In explaining that ruling, the Second Circuit in *Stratte-McClure* indicated that it views an issuer's failure to disclose Item 303 information to be an actionable half-truth fraud under Rule 10b-5(b). *Id.* at 101. Indeed, the Second Circuit directly quoted the language of Rule 10b-5(b), stating that, "failing to comply with Item 303 by omitting known trends or uncertainties" is actionable inasmuch as "Rule 10b-5 requires disclosure of 'material fact[s] necessary in order to make ... statements made ... not misleading.'" *Id.* (quoting 17 C.F.R. § 240.10b-5(b)).

The Second Circuit was mistaken, however, in its reference to Rule 10b-5(b). Its rulings in *Stratte-McClure* – and in the instant case – do *not* comport with that subsection of the Rule (or any other part of the Rule), or the half-truth-fraud principles on which the relevant language in subsection (b) is based.

Rule 10b-5(b) contains two prongs. The first prong prohibits affirmative misstatements.[3] The second prong provides: "[i]t shall be unlawful ... to omit to state a material fact necessary in order to make the statements made ... not misleading ... in connection with the purchase or sale of any securi-

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[3] 17 C.F.R. § 240.10b-5(b) ("it shall be unlawful ... to make any untrue statement of a material fact ..."). This first prong covers statements that are outright falsehoods, in contrast with half-truths, which are statements that are literally "true" but nonetheless misleading.

ty." 17 C.F.R. § 240.10b-5(b). This second prong reflects the common-law principles of a "half-truth" fraud. *U.S. v. Laurienti*, 611 F.3d 530, 539 (9th Cir. 2010) ("Subsection (b) of Rule 10b-5 prohibits the telling of material lies and prohibits the telling of material *half-truths*") (emphasis added).[4] Under the plain meaning of the second prong of Rule 10b-5(b) – and likewise under the common law – fraud is found only when a plaintiff identifies an affirmative false statement that amounts to an actionable half-truth.

A. The Second Circuit's Holding Cannot Be Reconciled With Half-Truth-Fraud Principles

A half-truth, as set forth in Rule 10b-5(b), is an affirmative statement that is literally true, but omits information that is necessary to prevent the statement from being misleading. *See, e.g., In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223, 239-40 (2d Cir. 2016) ("'half-truths [are] statements that are misleading ... by virtue of what they omit to disclose"). In other words, a half-truth contains a partial disclosure of facts that is misleading in the absence of certain additional facts. A person who makes an affirmative statement is said to be under a "duty to disclose" the missing information. *See Laurienti*, 611 F.3d at 541. The duty arises solely

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[4] *See also, e.g., SEC v. Gabelli*, 653 F.3d 49, 57 (2d Cir. 2011), *rev'd on other grounds,* 568 U.S. 442 (2013) ("so-called half truths ... will support claims for securities fraud" under Rule 10b-5).

from the telling of a potentially misleading statement, independent of any other duties that the declarant may have. *Id.* Finally, half-truth liability is imposed only when a declarant speaks on a *particular* topic and omits information regarding the *same* topic necessary to render the initial statement not misleading. *See, e.g.*, *In re Pharm., Inc. Sec. Litig.*, No. CIV A 04-12581-GAO, 2007 WL 951695, at *4 (D. Mass. Mar. 28, 2007).

Given the nature of half-truth fraud, the only fraud theory regarding "trends" and "uncertainties" that could conceivably comport with Rule 10b-5(b) is a theory asserting that affirmative statements made in an issuer's periodic filings were misleading due to the failure to disclose certain trends and uncertainties.

It bears emphasis that under such a Rule 10b-5(b) theory, it would not matter whether the trends and uncertainties at issue were otherwise the subject of some statutory or regulatory requirement (*e.g.*, Item 303). Simply put, affirmative statements in an issuer's financial statements either are misleading half-truths in the absence of other information, or they are not. If the statements *are* misleading half-truths, they are potentially actionable under Rule 10b-5(b) even if some other regulation or statute does *not* require the disclosure of additional information. By the same token, if statements are *not* misleading half-truths, they are *not* actionable under Rule 10b-5(b) even if some other regulation or statute *does* require the missing information to be disclosed. In short, whether a statement is misleading under Rule 10b-5(b) does not turn on the existence of an independ-

ent statutory or regulatory disclosure duty with regard to the information at issue.

Significantly, the foregoing fraud theory is *not* the fraud theory espoused by the Second Circuit – *i.e.*, the Second Circuit does *not* posit that what makes an issuer's periodic disclosures misleading is the mere absence of material information about known trends and uncertainties. Nor *could* the Second Circuit have properly adopted such a theory, because it proves too much. After all, anytime an issuer presents some, but not all, known financial information, it can be argued that shareholders are thereby getting a picture of the company's financial condition that is "incomplete." But if an issuer's financial statements in their entirety were considered misleadingly incomplete whenever they omit material financial information – be it material information on "trends" and "uncertainties" or any other financial information – issuers effectively would be under a duty to disclose *all* material financial information anytime they present *any* material financial information.

This Court has never recognized such a sweeping duty. To the contrary, the Court has made clear no such duty exists. *See Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44 (2011) ("section 10(b) and Rule 10b-5 do not create an affirmative duty to disclose any and all material information"); *see also, e.g., In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) (no duty to disclose material financial information "merely because a reasonable investor would very much like to know" that information). Indeed, virtually every circuit that has examined the issue has held that

incomplete statements are not actionable, rather only misleading statements are actionable. *See, e.g.*, *In re Rigel Pharms., Inc. Sec. Litig.*, 697 F.3d 869, 880 n.8 (9th Cir. 2012) ("[S]ection 10(b) and Rule 10b–5 prohibit only misleading and untrue statements, not statements that are incomplete."); *Indiana Elec. Workers' Pension Trust Fund v. Shaw Group*, 537 F.3d 527, 541 (5th Cir. 2008) (An "incomplete disclosure is actionable only if what they said is misleading"); *Winer Family Trust v. Queen*, 503 F.3d 319, 330 (3d Cir. 2007) ("Liability may exist under Rule 10b–5 for misleading or untrue statements, but not for statements that are simply incomplete.").[5]

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[5]To be sure, if an issuer makes affirmative statements regarding some specific subject – *e.g.*, "trends" and "uncertainties" – then the issuer is under a duty to fully disclose related material facts *on the same subject* in the absence of which the issuer's affirmative statements would be misleading and give rise to liability under Rule 10b-5(b). Indeed, every circuit court to consider the issue has concluded that the half-truth theory of liability requires the actionable omission to be on the same specific topic as the affirmative statement made. *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245, 250 (2d Cir. 2014); *FindWhat Investor Grp. v. FindWhat.com*, 658 F.3d 1282, 1305 (11th Cir. 2011); *In re K-Tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 898 (8th Cir. 2002). Even this potential source of liability, however, is subject to strict limitations: "[m]erely mentioning a topic ... does not require the company to disclose every tangentially related fact that might interest investors." *Anderson v. Abbott Labs.*, 140 F. Supp. 2d 894, 903 (N.D. Ill.), *aff'd*

The requirement that a plaintiff asserting a half-truth theory must plead the existence of a particular affirmative statement (as opposed, for example, to an entire document) that is allegedly made misleading as a result of the omission also is reflected in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The PSLRA mandates that a plaintiff identify exactly which specific statements are made misleading by the omissions at issue, and the reason or reasons each particular statement is misleading. 15 U.S.C. § 78u-4(b)(1)(B); *see also, e.g., Anderson*, 140 F. Supp. 2d at 903-04 (plaintiffs' failure to identify specific statements made misleading by defendants' omissions "fatal to th[eir] claims").[6] In sum, the plain language of Rule 10b-5(b) and the PSLRA both make clear that a half-truth-fraud claim must be predicated on a specific, identifiable affirmative statement.

In *Stratte-McClure* and the instant case, however, the Second Circuit does not even purport

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sub nom. Gallagher v. Abbott Labs., 269 F.3d 806 (7th Cir. 2001).

[6] *See also In re Vivendi S.A. Sec. Litig.*, 838 F.3d 223, 241 (2d Cir. 2016) (proposed jury form inadequate because it "fail[ed] to identify a discrete set of statements [and] might thus invite a verdict that would be inconsistent with" Rule 10b-5; plaintiffs therefore required to propose verdict form "that identified specific misstatements ... [and] ask[], with respect to each statement ... whether 'plaintiffs have proven each element of their Section 10(b) claim.'").

to identify any specific affirmative statements on any particular topic made by the issuers that would have triggered a duty to disclose further material information regarding "trends" and "uncertainties." The Second Circuit merely references an entire periodic filing (in *Stratte-McClure*, a Form 10-Q, and in the instant case, a Form 10-K). Relying in this holistic fashion on an issuer's entire periodic filing without identifying specific alleged false and misleading statements on particular topics, does not satisfy the requirements of Rule 10b-5(b), or the requirements of the PSLRA. The Second Circuit's failure to identify any such specific affirmative misstatements further indicates that although the Second Circuit in *Stratte-McClure* points specifically to Rule 10b-5(b), its analysis and holding do not actually comport with that subsection.

Finally, the case law on which the Second Circuit relies demonstrates that there is no basis in Rule 10b-5(b) or the half-truth rule for the court's holding. In support of its conclusion that the failure to disclose known trends and uncertainties can give rise to fraud liability, the Second Circuit in *Stratte-McClure* points to four circuit court decisions. 776 F.3d at 102 (*citing Glazer v. Formica Corp*., 964 F.2d 149, 157 (2d Cir. 1992); *Backman v. Polaroid Corp*., 910 F.2d 10, 20 (1st Cir. 1990) (*en banc*); *Oran v. Stafford*, 226 F.3d 275, 285-86 (3d Cir. 2000); *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir. 2001)). None of these decisions, however, found liability under Rule 10b-5(b) based on a failure to disclose information required to be

disclosed by a statute or regulation.[7] Indeed, the portions of the four decisions cited in *Stratte-McClure* do not even specifically discuss Rule 10b-5(b) or mention half-truth fraud.

B. The Second Circuit's Holding Is Grounded In A "Pure Omission," Rather Than A Half-Truth

As demonstrated above, despite the Second Circuit's reference in *Stratte-McClure* to Rule 10b-5(b), the *substance* of the Second Circuit's holding is incompatible with half-truth fraud.

In explaining its holding, the Second Circuit in *Stratte-McClure* began by emphasizing that under its analysis, what serves as the "basis for a securities fraud claim" is a violation of "Item 303's affirmative duty to disclose in Form 10-Qs." 776 F.3d at 101. The Second Circuit went on to explain

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[7]This line of cases traces back to the First Circuit's opinion in *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987). *See Glazer*, 964 F.2d at 157 (citing *Roeder*); *Backman*, 910 F.2d at 20 (same). In *Roeder*, the First Circuit notes the plaintiff's argument that "a corporation has an affirmative duty to disclose all material information even if there is no insider trading, no statute or regulation requiring disclosure, and no inaccurate, incomplete, or misleading prior disclosures." *Roeder*, 814 F.2d at 27. The court then flatly rejects this argument. *Id.* The Second Circuit's reliance on *Roeder* and its progeny is unavailing. The Second Circuit's determination that Item 303 affirmatively creates a duty of disclosure actionable under Section 10(b) is an insupportable extension of the law all its own.

exactly how, in the court's view, a violation of Item 303 misleads investors: "Due to the obligatory nature of [Item 303], a reasonable investor would interpret the *absence* of an [Item 303] disclosure to *imply the nonexistence* of 'known trends or uncertainties ... that the registrant reasonably expects will have a material ... unfavorable impact on ... revenue or income from continuing operations." *Id.* at 102 (emphasis added).

This explanation is revealing. It makes clear that the Second Circuit's fraud theory is based on a *pure omission*, not a half-truth. A pure omission is a complete failure to make a statement, as contrasted with a half-truth, which involves the making of an affirmative statement that is misleadingly incomplete. *See, e.g., Litwin v. Blackstone Group L.P.*, 634 F.3d 706, 719 (2d Cir. 2011). Fraud liability arises from a pure omission where one "fails to disclose to another a fact ... [in circumstances in which it is] *as though* he had *represented the nonexistence* of the matter that he has failed to disclose." Restatement (Second) of Torts § 551 (1977) ("Liability for Nondisclosure") ("Section 551") (emphasis added). The Second Circuit's fraud theory similarly seeks to predicate liability on an implicit representation of the "nonexistence of [a] matter" (*id.*) – *i.e.*, the Second Circuit's theory suggests that fraud liability arises from an issuer's failure to disclose Item 303 trends and uncertainties because that failure "impl[ies]" the "nonexistence" of such trends and uncertainties. *See Stratte-McClure*, 776 F.3d at 102.

But Rule 10b-5(b) does not cover pure omissions. As shown above, it is clear from the plain

language of subsection (b) that it only covers affirmative misstatements and half-truths. That Rule 10b-5(b) does not cover pure omissions (including omissions of facts required to be disclosed by statute or regulation) is also confirmed by a comparison of the Rule with Sections 11 and 12 of the 1933 Act. Section 11, for instance, permits civil suits by purchasers of securities where the registration statement "contain[s] an untrue statement of a material fact or *omit[s] to state a material fact required to be stated therein* or necessary to make the statements therein not misleading." 15 U.S.C. § 77k (emphasis added). Section 12 contains similar language. 15 U.S.C. § 771.

Thus, the plain language of Sections 11 and 12 indicates that liability under these sections was intended to arise from an issuer's *omission of facts required to be disclosed.* Neither subsection (b) nor any other subsection of Rule 10b-5 contains any such language – which confirms that Rule 10b-5(b) was not intended to cover such omissions. The absence of such language in Rule 10b-5(b) further exposes that the Second Circuit erred in *Stratte-McClure* when it suggested that liability under Rule 10b-5(b) can arise from a pure omission. *See, e.g., In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1055-56 (2014).

II. THE SECOND CIRCUIT'S HOLDING IS AN UNWARRANTED EXPANSION OF THIS COURT'S SECTION 10(b) JURISPRUDENCE

As shown in Section I above, the Second Circuit's fraud theory in this case does not comport

with the common-law half-truth doctrine or Rule 10b-5(b). The question that remains is whether the Second Circuit's theory satisfies the requirements for fraud under Section 10(b) on some basis *other than* Rule 10b-5(b) (even though the Second Circuit itself appeared to think that only that provision was applicable). The answer to that question is a resounding no. For the reasons detailed below, breaching a disclosure obligation under Item 303 does *not* satisfy the requirements of a viable fraud-by-omission claim under traditional common-law fraud principles, nor does it comport with this Court's established jurisprudence with respect to Section 10(b) and subsections (a) and (c) of Rule 10b-5.[8]

A. The Second Circuit's Holding Does Not Comport With The Common Law Of Fraud By Omission

The Second Circuit's theory of fraud on which the court's holdings rely does not comport with the common law of fraud by omission. The common law of fraudulent omission is reflected in Section 551 of the Restatement of Torts. Section 551 provides that a party to a business transaction

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[8]Rule 10b-5(a) and (c) provide that is shall be unlawful "(a) [t]o employ any device, scheme, or artifice to defraud, [or] ... (c) [t]o engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

who fails to disclose certain information that "induces the other to act or refrain from acting" in the business transaction, "is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, *if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question*." Restatement (Second) of Torts § 551 (1977) (emphasis added).

Section 551 specifies only five narrow fact patterns in which "one party to a business transaction is under a duty to exercise reasonable care to disclose" the information at issue "to the other [party] before the transaction is consummated." *Id.* at § 551(2). Under the first fact pattern, a party to a business transaction is potentially liable for fraudulent omission if the person fails to disclose to the other party to the transaction "matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." *Id.* at § 551(2)(a). Section 551 then identifies four other (even more uncommon) fact patterns, each one of which concerns the "parties to a transaction."[9]

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[9]Under the other fact patterns set forth in Section 551, a party to a transaction is required to disclose: "(b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and (c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true

An issuer's nondisclosure of trends and uncertainties required to be disclosed in Item 303 does not rise to the level of an actionable nondisclosure under Section 551 of the Restatement of Torts for two distinct reasons.

To begin with, fraud liability for a pure omission under the common-law principles reflected in Section 551 attaches only where the nondisclosure by a defendant occurs in connection with a transaction to which the defendant is a party. *Id.* In the instant case (as in *Stratte-McClure*), the issuer plainly did not omit to disclose information required by Item 303 in connection with any transaction to which the issuer is a party. On this basis alone, it is clear that the Second Circuit's theory of fraud by pure omission, on which its holdings in the instant case and *Stratte-McClure* are based, does not comport with the common law of fraud by omission.

There is a second, independent reason why the Second Circuit's fraud theory is inconsistent

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or believed to be so; and (d) the falsity of a representation not made with the expectation that it would be acted upon, if he subsequently learns that the other is about to act in reliance upon it in a transaction with him; and (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts." *Id. at* § 551.

with the common law as reflected in Section 551. Section 551 specifies that there must be either "a fiduciary or other similar relation of trust and confidence between" the person who fails to disclose the information at issue, and the other party to the transaction, or some other special circumstances as enumerated in Section 551. No such special circumstances are present in the instant case (or in *Stratte-McClure*). Indeed, the common law is clear that there is no actionable fiduciary or fiduciary-like relationship between an issuer and its shareholders that would support liability under Section 551.[10] None of the other special circumstances set forth in Section 551 apply in the instant case (or in *Stratte-McClure*) either.

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[10] *See, e.g.*, *In re Wayport, Inc. Litig.*, 76 A.3d 296, 322–23 (Del. Ch. 2013); *Alessi v. Beracha*, 849 A.2d 939 (Del. Ch. 2004). The leading state court for fiduciary duty disputes – Delaware – has resoundingly rejected the notion that an issuer is a fiduciary of its shareholders. *Wayport*, 76 A.3d at 322–23. Delaware courts have repeatedly rejected breach-of-fiduciary-duty claims directed at corporations. *See, e.g.*, *A.W. Fin. Servs., S.A. v. Empire Res., Inc.*, 981 A.2d 1114, 1127 n.36 (Del. 2009) ("Under Delaware law, the issuing corporation does not owe fiduciary duties to its stockholders.").

B. The Second Circuit's Holding Conflicts With The Supreme Court's Section 10(b) And Rule 10b-5 Jurisprudence Regarding Fraud By Omission

The fraud theory first adopted by the Second Circuit in *Stratte-McClure* and followed by the Second Circuit in the instant case also does not comport with the Supreme Court's Section 10(b) jurisprudence on fraudulent omissions. That jurisprudence very closely aligns with the common-law analysis described above – and with good reason. The Supreme Court has repeatedly made clear that its Section 10(b) jurisprudence is consciously informed by common-law principles of fraud.[11]

Indeed, in *Chiarella*, the Supreme Court *expressly cited Section 551 of the Restatement of Torts* in examining when one may be liable for failing to disclose information where the failure to disclose does not result in a misrepresentation.[12] *Chiarella*

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[11]*See, e.g.*, *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980); *Santa Fe Indus.*, *Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

[12]Traditionally, in common law, there was a cause of action for misrepresentations or half-truths, but not for the nondisclosure of material facts. *See* Frank Coulom Jr., *Rule 10b–5 and the Duty to Disclose Market Information: It Takes a Thief*, 55 St. John's L. Rev. 93, 96-97

– and *O'Hagan,* which relied on *Chiarella* in adopting the "misappropriation theory" of insider trading[13] – are the Supreme Court's notable Section 10(b) fraud-by-omission cases. These cases construed and applied Section 10(b) and Rule 10b-5 – in particular, subsections (a) and (c) of Rule 10b-5 – and in both those cases, the Court predicated liability for a fraudulent omission on the presence of two elements. The first element was a transaction (specifically, a transaction involving insider trading) to which the defendant was a party and in connection with which the defendant made personal use, for his own personal benefit, of the material nonpublic information at issue. *O'Hagan*, 521 U.S.

(2012). This rule, based on the principle of *caveat emptor*, served to reward diligence and business savvy. *Id.* Nevertheless, there was an exception to this general rule, where there was a fiduciary relationship between the parties. *Id.* For example, such a duty only arose where there was a principal-agent, executor-beneficiary, or trust relationship. *Id.* This duty did not apply to arm's-length commercial transactions. *Id.* The Court in *Chiarella* followed this common-law precedent, citing the Restatement of Torts section 551, which provides that "the duty to disclose arises when one party has information 'that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" 445 U.S. at 228. Accordingly, the Court held that Section 10(b) liability can be "premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Id.* at 230.

[13] *U.S. v. O'Hagan*, 521 U.S. 642 (1997).

at 652; *Chiarella*, 445 U.S. at 229. The second element was a special relationship – in particular, a relationship of trust and confidence. *O'Hagan*, 521 U.S. at 652; *Chiarella*, 445 U.S. at 228.

With regard to the first of these two elements, it bears emphasis that the Supreme Court's analysis of nondisclosure liability in both *Chiarella* and *O'Hagan* entirely depended on the presence of a transaction to which the defendant was a party and in connection with which the defendant had made personal use of the material non-public information at issue.[14] Simply put, under the Court's analysis in both *Chiarella* and *O'Hagan*, if there is no transaction at issue to which the defendant is a party, there can be no liability for a fraudulent omission under 10(b). *See, e.g., O'Hagan,* 521 U.S. at 656 ("the fiduciary's fraud is consummated, not when the fiduciary gains the

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[14]*See, e.g., O'Hagan*, 521 U.S. at 651-52 ("Under the 'traditional' or 'classical' theory of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider *trades* in the securities of his corporation on the basis of material, nonpublic information ... ") (emphasis added); *see also, e.g., id.* ("The 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information *for securities trading purposes*, in breach of a duty owed to the source of the information ... ") (emphasis added); *see also Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152 (1972).

confidential information, *but when*, without disclosure to his principal, he *uses* the information to purchase or sell securities. *The securities transaction and the breach of duty thus coincide.*") (emphasis added); *see also Chiarella*, 445 U.S. at 230.[15] Absent the insider-trading transaction that was present in both *Chiarella* and *O'Hagan*, the defendant in each of those cases would have been under no duty to make any disclosure, much less liable under Section 10(b) for breaching such a duty.

The Second Circuit's holdings in the instant case and *Stratte-McClure* squarely conflict with the foregoing Section 10(b) jurisprudence from this Court. The Second Circuit imposes fraud liability for an omission by an issuer in connection with the issuance of its quarterly and yearly financial results and yet the issuer was *not* itself participating in any business transaction with its investors to which it was a party when it published those results. Moreover, as a matter of law, the issuer did *not* have an actionable fiduciary relationship with its shareholders in connection with the issu-

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[15]In *Chiarella*, in the same passage in which the Supreme Court cited Section 551, the Court cited approvingly a law review article discussing instances of nondisclosure liability under the common law (as reflected in Section 551). In every instance the defendant was a party to a transaction. 445 U.S. at 228-230, & n. 9 (citing James & Gray, Misrepresentation – Part II, 37 Md. L. Rev. 488, 523-527 (1978).

ance of its financial results. For these reasons, the Court should reject the Second Circuit's fraud theory. Adopting that theory would amount to a substantial and unwarranted departure from the Court's Section 10(b) jurisprudence and its long-standing adherence to common-law principles in its analysis and application of Section 10(b) and Rule 10b-5.

Indeed, it is a bedrock principle of Section 10(b) jurisprudence – which this Court has repeatedly reaffirmed – that although what Section 10(b) was designed to catch was fraud, it is not to be construed as encompassing the entirety of the common law of fraud.[16] Indeed, there are some instances of common-law fraud relating to the purchase or sale of securities that do not amount to violations of Section 10(b).[17] *See, e.g., SEC v.*

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[16]*Chiarella*, 445 U.S. at 234-35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."); *see also Dirks v. SEC*, 463 U.S. 646, 657 (1983) (a duty to speak "attaches only when a party has legal obligations other than a mere duty to comply with general antifraud proscriptions in the federal securities laws.").

[17]Just as Section 10(b) is limited in this regard, so too is Rule 10b-5. *See, e.g., O'Hagan*, 521 U.S. at 651 ("liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition" (citing *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 214 (1976) (scope of

Zandford, 535 U.S. 813, 820 (2002) ("[Section 10(b)] must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation"); *Central Bank v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 184 (1994) ("Even assuming ... a deeply rooted background of aiding and abetting tort liability, it does not follow that Congress intended to apply that kind of liability to the private causes of action in the securities Acts"); *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud"); *see also Dura Pharms. Inc. v. Broudo*, 544 U.S. 336, 334 (2005).

Because this Court has thus made clear that Section 10(b) does not capture every kind of common-law fraud, *a fortiori*, the Court should not embrace a fraud theory like the Second Circuit's that does not even comport with the common law.[18]

Rule 10b-5 cannot exceed power Congress granted Commission under § 10(b))).

[18]Moreover, this Court has rightfully and repeatedly recognized that "[c]oncerns with the judicial creation of a private cause of action caution against its expansion." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 165 (2008); *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011). As such, the Court "must give 'narrow dimensions ... to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'" *Id.* A determination that an omission pursu-

III. If This Court Were To Adopt The Second Circuit's Fraud Theory, It Would Undermine The Purpose And Benefits Of Item 303 And Trigger A Wave Of Unwarranted Federal Securities Fraud Actions

For the reasons shown in Parts I and II above, this Court should reject the Second Circuit's holding, and adopt the holding from the Ninth Circuit that Item 303 does *not* create a duty to disclose for purposes of Section 10(b) and Rule 10b-5. *See In re NVIDIA Corp. Sec. Litig.*, 768 F.3d at 1056. In addition to the Ninth Circuit's holding finding firm support in this Court's Section 10(b) jurisprudence, it is supported by critical public-policy implications. The Court routinely considers public policy when interpreting Section 10(b) and Rule 10b-5. *See Blue Chip Stamps*, 421 U.S. at 737 (finding it "proper that [the Court] consider ... what may be described as policy considerations when we come to flesh out the portion of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance."). Adopting the Second Circuit's holding would undermine the purpose and benefits of Item 303, and trigger a deluge of disclosures and a spike in shareholder litigation.

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ant to Item 303 is actionable under Section 10(b) – when such an omission is not even actionable under basic principles of the common law of fraud – hardly gives the appropriately "narrow dimensions" to Section 10(b) that the Court has mandated. *See supra* at II.A.

A. Adopting The Second Circuit's Holding Would Undermine The Purpose And Benefits Of The MD&A Portion Of A Company's Public Filings

The MD&A is intended to be helpful to readers and easy to follow and understand. Item 303 requires corporate management, as part of the MD&A, to "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii). Its purpose is threefold: (1) "to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management"; (2) "to enhance the overall financial disclosure and provide the context within which financial information should be analyzed"; and (3) "to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance." Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746].

Indeed, the SEC urges companies to avoid "unnecessary duplicative disclosure that can tend to overwhelm readers" and to "focus on material information and eliminate immaterial information that does not promote understanding of companies'

financial condition." Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8350; 34-48960 (Dec. 29, 2003). Moreover, "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." *Id.*[19]

In contrast, the purpose of Section 10(b) and Rule 10b-5 are to prevent, and make actionable, fraud. Item 303 and Section 10(b) have different purposes and different standards, as the SEC, itself, has recognized: "MD&A mandates disclosure of specified forward-looking information, and specifies its own standards for disclosure – *i.e.*, reasonably likely to have a material effect. The specific standard governs the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved by the Supreme Court in *Basic v. Levinson*, 485 U.S. 224 (1988), is inapposite to Item 303 disclosure." Commission Guidance, Release Nos. 33-8350; 34-48960, at Note 6.

If companies are faced with the specter of Section 10(b) claims for failure to make adequate

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[19]To date, the Court has been careful to avoid an interpretation of Section 10(b) that would lead management "simply to bury the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decision making." *Basic v. Levinson*, 485 U.S. 224, 231 (1988).

Item 303 disclosures, it will lead to a deluge of disclosures being included in the MD&A section and wipe out the purpose and benefits of Item 303. This is particularly true for public companies that operate in regulated markets. For example, pharmaceutical companies that are in discussions with the FDA have, to date, not been required to speak regarding their interactions with the FDA. *See, e.g.*, *In re Sanofi Sec. Litig.*, 87 F. Supp. 3d 510, 541 (S.D.N.Y. 2015) ("courts have rejected claims of material omissions where pharmaceutical companies did not reveal procedural or methodological commentary, or other interim status reports, received from the FDA as to drugs under review.") (citing numerous cases).

Courts have adopted this jurisprudential rule because interim FDA feedback is not material as it "does not express a binding agency decision and is subject to change as the FDA and pharmaceutical companies work together to develop viable clinical trials and approvable licensing applications." *Id.* at 542. Nevertheless, pharmaceutical companies and life sciences companies are one of the groups of companies that are most often sued in securities class actions. *See Securities Class Action Filings—2016 Year in Review*, Cornerstone Research, at 29 (complaints filed against biotechnology, pharmaceutical, and healthcare companies accounted for over 30% of all securities class-action complaints in 2016).

Further, plaintiffs often make the claim that the company failed to disclose information about the product or its interactions with the FDA and attempt to find a statement in the company's public

filings that plaintiffs can claim was misleading. If the Second Circuit's view of Item 303 is adopted, then virtually any communication or interaction with the FDA could be reformulated into a violation of Item 303. And companies arguably would lose the protection afforded to them under *Matrixx*, *i.e.*, that they can control what they disclose by controlling what they say to the market. *See Matrixx Initiatives*, 563 U.S. at 44.

Moreover, adopting a holding that an SEC rule – whether Item 303 or a different rule – creates a duty to disclose for the purposes of finding fraud under Section 10(b) would significantly broaden the scope of Section 10(b) liability. For example, a company could potentially be held liable for fraud for failing to disclose all properties where the company or its subsidiaries have operations pursuant to Item 102 or failing to disclose all market risks (which are inherently uncertain) under Item 304. It could not have been Congress's intent in 1934 that any and all SEC disclosure regulations potentially could serve as the basis for Section 10(b) liability. Otherwise, Congress simply would have used the same "omit[s] to state a material fact required to be stated therein" language found in Section 11 of the earlier Securities Act.

B. Adopting The Second Circuit's Holding Would Trigger An Unwarranted Spike In Shareholder Litigation

There can be little doubt that adopting the Second Circuit's holding will cause a flood of litiga-

tion.[20] The plaintiffs' bar will seize the opportunity to attack companies' periodic filings for alleged Item 303 deficiencies. Further, they will do so without having to identify any statement that is actually misleading. This would substantially obviate the PSLRA's pleading requirement that the plaintiff identify the statement that is misleading

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[20]While Respondents may argue that the materiality element of a Section 10(b) claim will continue to be a significant barrier to lawsuits, it is unlikely to affect the filing of securities class-action complaints based on alleged omissions of information required by SEC rules to be disclosed. Courts rarely dismiss claims based on a failure to adequately plead materiality because materiality is "a mixed question of law and fact." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976); *see also Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) ("a complaint may not properly be dismissed ... on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance."). The plaintiffs' bar simply will argue that any stock-price drop that occurs once the information is disclosed is sufficient evidence of materiality at the motion-to-dismiss stage. *See, e.g.*, *In re Facebook, Inc., IPO Sec. & Derivative Litig.*, 986 F. Supp. 2d 487, 520 (S.D.N.Y. 2013) ("The market reaction to the revenue projections also supports the adequacy of the materiality allegations."); *Oran*, 226 F.3d at 282 ("when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock.").

and the reasons why the statement was misleading when made.

Adopting the Second Circuit's holding also will offer no additional benefit to shareholders. Item 303 disclosures are already mandatory and enforced by the Securities and Exchange Commission. *See, e.g.*, *In the Matter of Bank of America Corp.*, Release No. 72888 (Aug. 21, 2014); *In the Matter of Southpeak Interactive Corp. and Patrice K. Strachan*, Release No. 64320 (Apr. 21, 2011). Adopting the Second Circuit's theory of liability will not lead to more thoughtful disclosures. Quite the contrary, as addressed above, it will lead to an overabundance of disclosures – burying key information and placing an additional burden on shareholders to sift through disclosure-laden filings.

Moreover, if the Court adopts the Second Circuit's holdings and permits Section 10(b) actions premised on a duty to disclose under Item 303, there will be an increased number of meritless cases surviving motions to dismiss and class certification. To date, securities fraud-by-omission cases have been less frequent than misstatement cases. However, adopting the Second Circuit's holding coupled with the presumption of reliance established in *Affiliated Ute*, 406 U.S. at 153-54 will likely reverse that relative frequency.

Affiliated Ute established the presumption that "if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008) (citing

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972)). The presumption arises "if there is an omission of a material fact by one with a duty to disclose." *Stoneridge Inv. Partners LLC,* 552 U.S. at 159. "Requiring a plaintiff to show a speculative state of facts, *i.e.*, how he would have acted if omitted material information had been disclosed ... would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market." *Basic*, 485 U.S. at 245.

If the Supreme Court adopts the Second Circuit's theory, there will be an increase in the number of class actions alleging securities fraud by omission in a company's MD&A. These plaintiffs will rely on *Affiliated Ute* at the class-certification stage to establish a rebuttable presumption of reliance (a critical element of a Section 10(b) claim). The impact will be not only *more* securities class actions under Section 10(b), but more cases advancing beyond class certification. This will lead to protracted litigation, burden the courts, and drive up litigation and settlement costs for companies with no net benefit for shareholders and investors.

CONCLUSION

For all of the reasons set forth above, *amicus curiae* Washington Legal Foundation respectfully requests that this Court reverse the decision of the Second Circuit Court of Appeals.

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