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Unveiling Management's Crystal Ball

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INTRODUCTION

Have you ever wanted to look into a crystal ball and predict the future? Although not always accurate, most companies have the ability to look into their "crystal ball" and make predictions for the future of the business. Companies may disclose this forward-looking information to shareholders or potential investors, but may also choose not to unveil the crystal ball, considering that the predictions could have a negative impact on their current stock prices. If a company's investors suspect a company's statements were materially false or misleading, the investors may bring a securities fraud class action lawsuit, claiming the company omitted certain material forward-looking information that likely would have had a negative impact on revenues and profits.[1]

Item 303 under the Securities Act of 1933, as amended ("Securities Act"), the Securities Exchange Act of 1934, as amended ("Exchange Act"), and the Energy Policy and Conservation Act of 1975, as amended (collectively "Item 303") requires that reporting companies disclose information about the companies' plans and outlooks for the future of their businesses.[2] The Second and Ninth Circuits—the two United States circuit courts hearing the most securities fraud cases—have interpreted the jurisprudence differently and thus are divided on the legal consequences of management's failure to provide adequate forward-looking information.[3] The two interpretations come from a Third Circuit opinion about whether a material omission of Item 303 forward-looking information could be the foundation of a Rule 10b-5 securities fraud claim.[4] The Third Circuit reasoned that a violation of Item 303's reporting requirements[5]—the most

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1. *See* Item 303, 17 C.F.R. § 229.303 (2016).
2. *See id.*
3. John Stigi & Madalyn Macarr, *Second Circuit Notes Split with Ninth Circuit Over Whether Failure to Make Adequate Disclosures Under Item 303 of Regulation S-K May Serve as Basis for Section 10(b) Claim*, SHEPPARDMULLIN: CORP. & SEC. L. BLOG (Jan. 26, 2015), http://www.corporatesecuritieslawblog.com/2015/01/second-circuit-notes-split-with-ninth-circuit-over-whether-failure-to-make-adequate-disclosures-under-item-303-of-regulation-s-k-may-serve-as-basis-for-a-section-10b-claim/ [https://perma.cc/K88R-DGPK].
4. *Compare In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1054–55 (9th Cir. 2014), *cert. denied*, 135 S. Ct. 2349 (2015), *with* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 103–04 (2d Cir. 2015).
5. For a detailed explanation of Item 303's reporting requirements see *infra* Part I.E.

significant public disclosures focusing on current operations and management's plans for the future[6]—"does not automatically give rise to a material omission under Rule 10b-5" and result in related liability,[7] but the circuits have not universally accepted this reasoning.[8]

Some circuits, such as the Ninth Circuit, assert that Item 303 does not create a duty to disclose for purposes of Section 10(b) under the Exchange Act ("Section 10(b)") and SEC Rule 10b-5 promulgated under Section 10(b) ("Rule 10b-5").[9] However, other circuits, such as the Second Circuit, hold that a Section 10(b) claim arises when a company fails to make required Item 303 disclosures and the "materiality" requirements as set forth by the United States Supreme Court in *Basic v. Levinson* are satisfied.[10] While the United States Supreme Court had an opportunity to resolve this conflict in 2015, it refused to grant a writ of certiorari on this issue.[11]

To eliminate cross-circuit disparity and provide clarity regarding whether omitted Item 303 information is subject to a claim under Section 10(b) and Rule 10b-5, the United States Supreme Court should review the Ninth and Second Circuits' conflicting analyses when given the opportunity. Further, the Supreme Court should adopt the Second Circuit's conclusion and hold that failure to make a mandatory Item 303 disclosure is a material omission that can serve as the foundation for a securities fraud claim under Section 10(b) or Rule 10b-5, because Item 303 creates a duty to disclose material information.[12] This unifying effort helps achieve the

6. 2 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 9.4[7][C], at 30 (4th ed. 2002).

7. Oran v. Stafford, 226 F.3d 275, 288 (3d Cir. 2000). *See also* 17 C.F.R. § 229.303.

8. *Compare NVIDIA Corp. Sec. Litig.*, 768 F.3d at 1056 ("[I]tem 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5."), *with Stratte-McClure*, 776 F.3d at 100 ("[A] failure to make a required Item 303 disclosure . . . is indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim.").

9. *See, e.g.*, *NVIDIA Corp. Sec. Litig.*, 768 F.3d at 1056.

10. *See, e.g.*, *Stratte-McClure*, 776 F.3d at 100 (citing Basic Inc. v. Levinson, 485 U.S. 224 (1988)).

11. *See* Petition for Writ of Certiorari at i, Cohen v. NVIDIA Corp., 135 S. Ct. 2349 (2015) (No. 14-975) (declining to resolve "[w]hether Item 303 of Regulation S-K forms the basis for a duty to disclose otherwise material information for purposes of an omission actionable under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 as the Second Circuit recently held in direct conflict with the Ninth Circuit's holding in this case").

12. *See Stratte-McClure*, 776 F.3d at 101.

purpose of the Exchange Act.[13] Additionally, the circuits' agreement on the application of Item 303 in a 10b-5 class action lawsuit provides clear guidance to the investors and helps to promote integrity in the capital markets.[14]

This Comment proceeds in five parts. Part I provides background information concerning the Exchange Act and Rule 10b-5, including the Court's interpretation of materiality in *Basic Inc. v. Levinson*,[15] and Item 303.[16] Part II explains the evolution of the approach adopted by the Securities and Exchange Commission ("SEC") regarding the disclosure of forward-looking information.[17] This Part focuses primarily on the SEC's 1989 interpretative release, which illustrated the SEC's modern approach to Item 303 disclosures, demonstrating that the modern approach should not be used as a rationale for preventing private securities fraud causes of action.[18] Part III describes the differences between a private cause of action for securities fraud under Rule 10b-5 and the cease-and-desist powers of the SEC, including the benefits of both, demonstrating that the SEC's powers are an ineffective deterrent to securities fraud.[19] Part IV describes the various approaches courts have taken to Item 303, focusing on three recent holdings from the Second, Third, and Ninth Circuits.[20] Finally, Part V proposes that the Supreme Court adopt the findings in *Stratte-McClure v. Morgan Stanley*[21]—making a party liable for federal securities fraud

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13. The United States Supreme Court has repeatedly stated that the purpose of the Exchange Act is to implement a "philosophy of full disclosure." Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977)).

14. *See* Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1169 (2003) ("Section 10(b) and Rule 10b-5 were designed to protect investors and promote the integrity of our securities markets by preventing fraud, manipulation, and deception in connection with the purchase or sale of a security.").

15. The United States Supreme Court also analyzed the reliance factor of a 10b-5 class action lawsuit, proclaiming a presumption of reliance, but only the materiality analysis is relevant to this Comment. *See Basic*, 485 U.S. 224.

16. *See infra* Part I.A–E.

17. *See infra* Part II.A–B.

18. *See infra* Part II.A–B.

19. *See infra* Part III.A–B.

20. *See infra* Part IV.A–C.

21. The Second Circuit interpreted Item 303 as creating a disclosure duty. Stratte-McClure, 776 F.3d 94, 101 (2d Cir. 2015). Accordingly, if a class of investors satisfies the *Basic* materiality standard, as well as the additional 10b-5 elements, then the class could recover damages for fraudulent material omissions by a company. *See id*. at 100.

under Section 10(b) and Rule 10b-5 due to a material omission of Item 303 forward-looking information.[22]

I. PEEKING INTO MANAGEMENT'S CRYSTAL BALL

Rooted in the Exchange Act,[23] and, more specifically, promulgated by the SEC under Section 10(b),[24] Rule 10b-5[25] is designed to protect private investors and deter issuers of securities from engaging in fraudulent conduct.[26] Until 1980, when Regulation S-K was enacted, there were no means to satisfy the Exchange Act's disclosure requirements in an integrated manner.[27] Regulation S-K is a securities regulatory scheme that was designed to satisfy the filing requirements under the Securities Act[28] and the Exchange Act.[29] Particularly, Item 303 mandates that a company must file certain information with the SEC, including known trends and uncertainties relating to liquidity, capital resources, and results of operations.[30] Although the United States Supreme Court has proclaimed a basic rule for materiality,[31] the lower courts are split as to its application to a securities fraud lawsuit relating to a material omission of forward-looking information.[32]

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22. *See infra* Part V.

23. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2012).

24. *Id.* § 78j.

25. 17 C.F.R § 240.10b-5 (2016).

26. *See* Sargent v. Genesco, Inc., 492 F.2d 750, 760 (5th Cir. 1974) ("The basic intent of . . . [R]ule 10b-5 . . . is to protect investors and instill confidence in the securities markets by penalizing unfair dealings.").

27. *See* Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Acts Disclosure Systems, Exchange Act Release No. 33–6231, 45 Fed. Reg. 63,630 (Sept. 2, 1980) (codified as amended in scattered sections of 17 U.S.C.).

28. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa.

29. *See* Exchange Act Release No. 33–6231, *supra* note 27. Regulation S-K is a broad array of instructions to provide guidance to issuers as to the information they must provide in all documents filed with the SEC. This includes, but is not limited to, instructions for filing registration statements and periodic disclosure reports.

30. Item 303, 17 C.F.R. § 229.303.

31. *See* Basic Inc. v. Levinson, 485 U.S. 224, 238–39 (1988).

32. *Compare* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1056 (9th Cir. 2014), *cert. denied*, 135 S. Ct. 2349 (2015), *with* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 100 (2d Cir. 2015).

A. Congressional Creation of the Securities Exchange Act

Congress enacted landmark securities legislation in 1933 and 1934—the Securities Act[33] and the Exchange Act,[34] respectively (collectively "the Acts"). The purpose of the Acts was to protect investors by promoting transparency in the marketplace.[35] Similar to the Securities Act's mandate that issuers register their securities for the benefit of persons purchasing securities in primary markets, the policy underlying the Exchange Act requires the registration of securities to protect those investors purchasing in secondary markets.[36] In addition to Congress's explicit policy pronouncement for the Exchange Act, several other rationales underlie the enactment of the Exchange Act. A long line of cases support the assertions that "[m]anipulation and dishonest practices of the market place thrive upon mystery and secrecy"[37] and that the core purpose of the Exchange Act is to implement full disclosure.[38] The Supreme Court has also stated that the Exchange Act was promulgated to address investors' fear of being injured by manipulated stock prices.[39] One commentator has proclaimed that the purpose of the Exchange Act was to reform the markets to control speculation, prevent insider trading, and eliminate other forms of market manipulation.[40] Section 10(b) is an essential provision to prevent market manipulation.[41]

B. Section 10(b) Bars the Use of Manipulative or Deceptive Devices

Section 10(b) prohibits a person from employing or exercising "any manipulative or deceptive device or contrivance in contravention of such

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33. 15 U.S.C. §§ 77a–77aa.

34. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn.

35. Alison B. Miller, Comment, *Navigating the Disclosure Dilemma: Corporate Illegality and the Federal Securities Laws*, 102 GEO L.J. 1647, 1652 (2014).

36. *See generally* 15 U.S.C. §§ 77a–77aa; *see also id*. § 78b. For more information on the similar policies underlying the Acts, see CHARLES J. JOHNSON, JR. ET AL., CORPORATE FINANCE AND THE SECURITIES LAWS § 1.02–1.03 (5th ed. 2015).

37. Basic Inc. v. Levison, 485 U.S. 224, 230 (1988) (quoting H.R. Rep. No. 73-1383 (1934)).

38. *See, e.g.*, *id*. at 230 (citing Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477–78, (1977) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963))).

39. *Id*. at 230 (citing S.Rep. No. 73-792 (1934)).

40. Comment, *Market Manipulation and the Securities Exchange Act*, 46 YALE L.J. 624, 629 (1937).

41. *See* 15 U.S.C. § 78j.

rules and regulations as the Commission [SEC] may prescribe."[42] Section 10(b) was designed by Congress as a "catchall clause" to enable the SEC to deal with the evolving array of manipulative devices.[43] The Court argues that the legislative history of the Exchange Act fails to provide the intended scope of Section 10(b).[44] The applicability of Section 10(b) to certain private securities fraud causes of action remains unanswered.

C. The SEC Promulgates Rule 10b-5 to Create Liability for Materially Misleading Statements or Omissions

In 1942, the SEC wielded its authority under Section 10(b) and promulgated Rule 10b-5.[45] This rule makes it impermissible for any person engaged in the sale of securities "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security."[46] Moreover, the rule provides two additional restrictions.[47] A person must not engage in fraudulent acts by use of "any device, scheme, or artifice," nor "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . in connection with the purchase or sale of any security."[48] Rule 10b-5 has generally been viewed as a "fraud-based" remedy due to its scienter requirement.[49]

To recover damages in a private federal securities fraud action under Rule 10b-5, a party must satisfy the requirements implied by Section 10(b) as enumerated by the Supreme Court.[50] Section 10(b) and Rule 10b-5 promulgated under the Exchange Act require a plaintiff to prove the following: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[51]

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42. *Id.*
43. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976).
44. *Id.* at 202.
45. *Id.* at 195–96.
46. 17 C.F.R § 240.10b-5 (2016).
47. *See id.*
48. *Id.*
49. JOHNSON, JR. ET AL., *supra* note 36, § 5.02[C].
50. *See* Stoneridge Inv. Partners, LLC, v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008).
51. *Id.*

There is no express indication by Congress or the SEC that Section 10(b) or Rule 10b-5 provides a private civil remedy for violating said provisions.[52] But it is now generally accepted that Rule 10b-5 establishes an implied private remedy that is applicable to all purchases and sales of securities.[53]

D. A Uniform Standard of Materiality for a 10b-5 Action

The United States Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*[54] was confronted with what the standard for "materiality" is in the context of proxy statements.[55] The Court noted that the question of materiality was objective and involved "the significance of an omitted or misrepresented fact to a reasonable investor."[56] Announcing the "total mix" standard, the Court held that omitted facts are material when there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[57]

More than a decade later, in *Basic Inc. v. Levinson*, the Court again faced questions regarding the standard of materiality.[58] When asked to determine the proper standard of materiality for a 10b-5 securities fraud action in the context of preliminary corporate merger talks,[59] the Court adopted the *TSC Industries* materiality standard for Rule 10b-5 actions.[60] However, the Court noted that the *TSC Industries* standard may only be effective in this context for certain and clear information.[61] It was necessary that a new standard be created because the *TSC Industries*

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52. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976).

53. The United States Supreme Court has repeatedly stated that there is an implied cause of action under Section 10(b) and Rule 10b-5. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (first citing Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971), and then citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 150 (1972)). *See also* JOHNSON, JR. ET AL., *supra* note 36, §5.01[C].

54. 426 U.S. 438 (1976).

55. *Id*. at 448–49. A proxy statement is "[a]n informational document that accompanies a proxy solicitation and explains a proposed action (such as a merger) by the corporation." *Proxy Statement*, Black's Law Dictionary (10th ed. 2014).

56. *Ernst & Ernst*, 425 U.S. at 445.

57. *Id.* at 449.

58. *See* Basic Inc. v. Levinson, 485 U.S. 224, 226 (1988).

59. *Id.* at 226–27.

60. *Id*. at 232.

61. *Id. See also id.* at 232 n.9.

standard made it difficult to determine if a "reasonable investor" would consider omissions of speculative information significant.[62]

Thus, the Court announced a balancing test to determine the materiality of speculative or forward-looking information in the 10b-5 context.[63] A court must balance "the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[64] To determine the probability of the event occurring, "a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels" and "consider such facts as the size of the two corporate entities and of the potential premiums over market value" to determine the magnitude of the transaction.[65]

In a footnote, the Court noted that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5."[66] This statement has resonated throughout the courts and has proved to be extremely significant in the context of liability for forward-looking material omissions. A plain reading of Rule 10b-5 leads a reader to conclude that only existing facts, which are misleading and material, are actionable, but the Court effectively expanded the scope of Rule 10b-5 in *Basic* by recognizing that speculative, forward-looking information may be actionable under 10b-5 if it satisfies the balancing test for the materiality of speculative information.[67] Safe harbor provisions now protect issuers from liability when they disclose material forward-looking information with the SEC.[68]

E. Item 303 Mandates That a Company Must File Certain Material Information with the SEC

Item 303—Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")—requires issuers to disclose information, whether historical or forward-looking,[69] necessary to

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62. *See id.* at 232.
63. *Id.* at 238–40.
64. *Id.* at 238 (quoting SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 849 (2d Cir. 1968)).
65. *Id.* at 239.
66. *Id.* at 239 n.17.
67. *See* Miller, *supra* note 35, at 1654. *See also* 17 C.F.R. § 240.10b-5 (2016) ("It shall be unlawful . . . "[t]o make any untrue statement of a material *fact* or to omit to state a material *fact* necessary in order to make the statements made . . . not misleading . . . .") (emphasis added).
68. *See, e.g.*, 17 C.F.R. § 230.175.
69. In one SEC safe harbor provision, forward-looking information includes projections of financial information, a statement of management's plans and

permit "investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future."[70] Item 303 falls within the broad regulatory scheme of Regulation S-K,[71] and more narrowly within the subdivision for disclosures of financial information.[72] MD&A's principal purpose is to provide investors with the material information necessary to garner an understanding of a company's current and future financial standing.[73]

Item 303 requires that the issuer discuss its financial condition, changes in financial condition, and results of operations, focusing on a company's liquidity, capital resources, results of operations, off-balance sheet arrangements, and contractual obligations.[74] Not only must the required information be disclosed, but Item 303 includes a catchall provision, requiring an issuer to "provide such other information" to permit an investor to grasp an understanding of the issuer's financial condition, any changes to that financial condition, as well as the results of the issuer's operations.[75]

The issuer must disclose any "known trends" that are "reasonably likely" to materially increase or decrease the company's liquidity in any way,[76] describe its material commitments for capital expenditures, and disclose any known material trends in the company's capital resources.[77] Moreover, Item 303 requires an issuer to provide all known trends the issuer reasonably believes will materially alter net sales, revenues, or income and will continue for the foreseeable future to affect its SEC filings.[78] In addition, Item 303 requires a company to disclose certain off-balance sheet arrangements[79] and its contractual obligations.[80]

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objectives for future operations, and a statement of future economic performance contained in MD&A. *See id.*

70. Management's Discussion & Analysis of Financial Condition & Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835, 43 SEC Docket 1330 (May 18, 1989).

71. 17 C.F.R. § 229.10.

72. *Id.* § 229.300.

73. Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition & Results of Operation, Securities Act Release No. 8350, 81 SEC Docket 2905 (Dec. 19, 2003) (codified at 17 C.F.R. §§ 211, 231, 241).

74. 17 C.F.R. § 229.303(a).

75. *Id*.

76. *Id*. § 229.303 (a)(1).

77. *Id.* § 229.303(a)(2).

78. *Id.* § 229.303(a)(3)(ii).

79. *Id.* § 229.303(a)(4).

80. *Id.* § 229.303 (a)(5).

Item 303's instructions provide considerable guidance to registrants. The instructions mention the applicability of safe harbor provisions.[81] Item 303(c) provides that the statutory safe harbors provided in Section 27A of the Securities Act[82] and Section 21E of the Exchange Act[83] shall apply to forward-looking information disclosed, whether by an issuer or someone directly associated with the issuer, under Item 303.[84] In addition to the statutory safe harbors, the SEC promulgated Rule 175—a safe harbor for projections—to provide additional protection to a company disclosing forward-looking information.[85] Under this rule, forward-looking information is immune from liability when supported by a reasonable basis and made in good faith.[86] These safe harbor provisions protect mandatory forward-looking statements made pursuant to Item 303,[87] but these protections are inapposite when a company fails to disclose material information in MD&A regarding a particular uncertainty or trend.[88]

II. THE EVOLUTION OF THE SEC'S VIEW ON UNVEILING THE CRYSTAL BALL

MD&A has been described as one of the most challenging sections to prepare in a prospectus or other SEC filings.[89] As it relates to a Rule 10b-5 class action lawsuit, there is a lack of uniformity among the courts as to the proper standard of materiality to be used in determining what disclosure is required.[90] Some courts say it is the standard set forth by the SEC; others argue it is the standard set forth in *Basic* for speculative, forward-looking information.[91] This controversy has incidentally perplexed courts as to whether Item 303 creates a duty to disclose for purposes of a private securities fraud lawsuit.

81. *Id.* § 229.303 (c).

82. Securities Act of 1933, 15 U.S.C. § 77z–2 (2012).

83. Securities Exchange Act of 1934, 15 U.S.C. § 78u–5.

84. 17 C.F.R. § 229.303(c).

85. *Id*. § 230.175 (Rule 175).

86. *Id*.

87. *See id.* § 229.303(a); *see also* Brian Neach, Comment, *Item 303's Role in Private Causes of Action Under the Federal Securities Laws*, 76 NOTRE DAME L. REV. 741, 744–45 (2001).

88. *Id.*

89. JOHNSON, JR. ET AL., *supra* note 36, § 3.04[B].

90. *See, e.g.*, *In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1055 (9th Cir. 2014); *but see* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 100 (2d Cir. 2015).

91. *Id. See, e.g.*, *In re* NVIDIA Corp. Sec. Litig., 768 F.3d at 1055; *but see* *Stratte-McClure*, 776 F.3d at 100.

A. Traditional MD&A Disclosure Requirements

MD&A in federal securities law dates back to 1968 when the SEC adopted the Guides for Preparation and Filing of Registration Statements.[92] Until that time, the SEC barred registrants from including projections in prospectuses and reports filed with the SEC.[93]

In 1973, the SEC issued a statement that its position never was to require disclosure of projections and that its position was not going to change.[94] The SEC intended to take steps toward incorporating projections into the disclosure system, but it refused to determine if an issuer would be required to disclose its projections.[95] This statement marks the beginning of the SEC's transition in certain circumstances from prohibiting forward-looking information to requiring its disclosure. An SEC commissioner issued a statement proposing that the SEC would lift its prohibition on disclosing forward-looking projections for issuers who satisfy standards that would be determined at a later time.[96] Those issuers who elected to file projections would "be required to update those projections on a regular basis, as well as in the event of material changes in the projections."[97] Once a company started, it could not stop maintaining its forward-looking information.

In 1975, the SEC proposed a set of rules and forms to establish a sophisticated disclosure system for companies who sought to disclose forward-looking information.[98] Nearly one year later, the SEC decided to withdraw all but one of the proposals in the face of mounting legal, policy, and technical issues.[99] However, this was not the end of the journey. After the SEC's Advisory Committee on Corporate Disclosure recommended the SEC announce that companies should voluntarily disclose forward-

92. Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, 52 Fed. Reg. 13,715 (Apr. 17, 1987).

93. Statement by the Commission on the Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, 1 SEC Docket 11 (Feb. 2, 1973).

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. Rule and Form Proposals, Securities Act Release No. 5581, 6 SEC Docket 771 (Apr. 28, 1975); Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, 1978 WL 208169 (Nov. 7, 1978).

99. Notice of Adoption of Amendment to Rule 14a-9, Securities Act Release No. 5699, 9 SEC Docket 472 (Apr. 23, 1976); Securities Act Release No. 5992, *supra* note 98.

looking information,[100] the SEC issued a statement encouraging, but not requiring, the disclosure of management projections.[101]

B. Modern MD&A Disclosure Requirements

The SEC entered MD&A's modern era of disclosure in 1980 when it adopted the present form of disclosure requirements.[102] To improve disclosure, reduce the burdens associated with disclosure, and facilitate integrated disclosure under the Securities Acts, the SEC announced amendments to Form 10-K[103] and "to related forms, rules, regulations and guides under the [Acts]."[104] The final rule proposed an incorporated Form 10-K and the addition of Item 11 to Regulation S-K, which "would not specifically require projections or other forward-looking information, although the presentation of this type of information on a voluntary basis would be encouraged."[105] In 1981, after conducting a review of disclosures prepared in accordance with the newly adopted disclosure requirements, the SEC provided practitioners with guidance for MD&A.[106] The SEC eventually adopted the integrated disclosure system and included Item

100. *Id.*
101. *Id.*; *see also* Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 205 (5th Cir. 1988).
102. While the Commission's indecisive history of standards for forward-looking information may seem abstract, its progression can reasonably lead a person to conclude that the Commission was approaching a conclusory position in which there is a duty to disclose material forward-looking statements. *See* Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Acts Disclosure Systems, Exchange Act Release No. 33–6231, 45 Fed. Reg. 63,630 (Sept. 25, 1980) (to be codified in scattered sections of 17 C.F.R.).
103. Form 10-K is an annual report issued pursuant to Section 13 or 15(d) of the Exchange Act.
104. Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Acts Disclosure Systems, 45 Fed. Reg. 63,630.
105. SEC Release Notice, Securities Act Release No. AS-279, 20 SEC Docket 1308 (Sept. 2, 1980).
106. Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6349, 1981 WL 379268 (Sept. 28, 1981); *see also* Commission Guidance Regarding Management Discussion and Analysis of Financial Condition & Results of Operation, Securities Act Release No. 8350, Exchange Act Release No. 48,960, 68 Fed. Reg. 75,056 (Dec. 29, 2003).

303, or Management's Discussion and Analysis of Financial Condition and Results of Operation, in the final rule.[107]

1. The SEC's 1989 Interpretative Release Created the Current Circuit Split

In 1987, the SEC sought public comment on MD&A standards and on several proposed revisions.[108] It noted that issuers are not required, but are encouraged, to supply certain forward-looking information.[109] In 1989, the SEC issued a landmark interpretative release, which declared that Item 303 partially requires the disclosure of forward-looking information.[110] For example, the release stated, "MD&A requires discussions of 'known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.'"[111] MD&A's focus, illustrated in the Instructions to Item 303, is solely on known material events and uncertainties "that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."[112]

The SEC emphasized the difference between required and optional disclosures. A company is required to disclose forward-looking information under Item 303 when it concludes that it is reasonably expected that known trends, events, and uncertainties will have a material effect.[113] The information need not be disclosed when a company is merely "anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty."[114]

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107. Adoption of Integrated Disclosure System, Securities Act Release No. 6383, 47 Fed. Reg. 11,380 (Mar. 16, 1982) (codified in scattered sections of 17 C.F.R.).

108. Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, Exchange Act Release No. 24356, 52 Fed. Reg. 13,715 (Apr. 24, 1987).

109. *Id.*

110. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22,427 (May 24, 1989).

111. *Id.* at n.17.

112. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22,427 (May 24, 1989).

113. *Id.*

114. *Id.*

To assist companies in determining whether the specific forward-looking information in MD&A needs to be disclosed, the SEC created a two-prong test.[115] The two-prong assessment should be conducted when management knows of trends, demands, commitments, events, or uncertainties.[116] It requires management to ask:

> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure it required. (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.[117]

The SEC further noted that the Supreme Court's probability–magnitude test for materiality in *Basic v. Levinson* was inapposite for MD&A because MD&A requires specific disclosure and declares its own standard for disclosure.[118] This indicates the SEC's intention to make companies liable in court for federal securities fraud because the company has a duty to disclose material, forward-looking information. However, some courts have held that this is not the case.[119]

2. The SEC Provides Issuers Additional Guidance Regarding Item 303 Disclosures

The SEC did not issue another interpretive release providing issuers with additional guidance on how to respond to MD&A requirements until 2003.[120] It described MD&A's intent, namely to provide "readers with

115. *Id.*
116. *Id.*
117. *Id.*
118. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22,427 n.27 (May 18, 1989).
119. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22,427 (May 18, 1989).
120. *See* Commission Guidance Regarding Management Discussion and Analysis of Financial Condition & Results of Operation, Securities Act Release

information 'necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations,'" and claimed that MD&A was not particularly complicated.[121] This is striking considering the numerous safe harbors available to issuers providing forward-looking information under Item 303.[122]

The 2003 release reaffirmed that the purpose of MD&A is to allow an investor or interested party to look at a company "through the eyes of those who manage that business."[123] With regard to the focus and context of the MD&A, the SEC proposed that companies should eliminate immaterial information that does not relate to the issuer's financial condition, liquidity and capital resources, changes in financial condition, and results of operations from its MD&A disclosures."[124] The SEC further stated that MD&A aims to develop disclosure, which permits a contextual analysis of financial information and allows investors to determine if past performance is telling of future performance.[125]

III. THE SEC'S INSUFFICIENT REMEDIES CALL FOR UNVEILING THE CRYSTAL BALL

A sufficient remedy must be available to investors when a company abuses disclosure requirements. An investor must be able to adequately recover if a company fails to comply with Item 303's duty to disclose forward-looking information. The securities regulatory domain has two remedial bodies—the SEC and the courts. Each provides a distinct set of remedies.[126] Whether the SEC or the courts are the proper authority to

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No. 8350, Exchange Act Release No. 48,960, 68 Fed. Reg. 75,056 (Dec. 29, 2003).

121. JOHNSON, JR. ET AL., *supra* note 36, § 3.04[B] (quoting Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition & Results of Operation, Securities Act Release No. 8350, 68 Fed. Reg. 75,056 (Dec. 29, 2003)).

122. *See, e.g.*, Securities Act of 1933, 15 U.S.C. § 77z–2 (2012); *see also* Securities Exchange Act of 1934, 15 U.S.C. § 78u–5; 17 C.F.R. § 230.175 (2016).

123. Commission Guidance Regarding Management Discussion and Analysis of Financial Condition & Results of Operation, 68 Fed. Reg. 75,056.

124. *Id.*

125. *Id.*

126. The SEC may utilize its cease-and-desist powers to stop a company from engaging in fraudulent conduct, *see, e.g.*, 15 U.S.C. § 78u–3, while the courts may permit private parties to bring a class action lawsuit to remedy the injuries a company may have inflicted on its investors due to fraudulent conduct, *see, e.g.*, Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008).

remedy a material omission of forward-looking information is disputed.[127] The courts are the superior alternative because investors are offered remedial measures that the SEC has not brought to the table. Absent such a remedy, unveiling management's crystal ball, as it relates to recovering damages, is completely irrelevant to investors.

A. The SEC's Cease-and-Desist Power is an Insufficient Remedy to Victims of Item 303 Securities Fraud

To prevent a business from engaging in fraudulent or manipulative conduct, the SEC may grant a cease-and-desist order, directing a person to halt illegal acts at the time of the order, as well as in the future.[128] Section 8(A) of the Securities Act,[129] Section 21C(a) of the Exchange Act,[130] and other federal statutes grant the SEC the power to issue a cease-and-desist order to any person who is violating, has violated, or is about to violate any provision of federal securities laws.[131] The Securities Enforcement Remedies Act provides the SEC with the power to punish issuers improperly disclosing or failing to disclose information through broad cease-and-desist authority.[132]

Upon finding that a business has violated or will violate a provision of the Acts, the SEC may publish its findings and issue an order requiring the business "to [cease and desist] from committing or causing such violation and any future violation."[133] Moreover, the cease-and-desist order may

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127. *See In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1056 (9th Cir. 2014); *but see also* Stratte-McClure v. Morgan Stanley, 776 F.3d 94 (2d Cir. 2015).

128. Dhaivat H. Shah, *The Care and Feeding of an SEC Cease-and-Desist Order: The Commission Defines Its Authority Through "in the Matter of KPMG Peat Marwick, LLP,"* 25 HAMLINE L. REV. 271, 272 (2002).

129. Securities Act of 1933, 15 U.S.C. § 77h-1.

130. *Id*. § 78u-3.

131. *See id*. §§ 77h-1(a), 78u–3(a); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, 80b-9 (2012); *see also* Andrew M. Smith, *SEC Cease-and-Desist Orders*, 51 ADMIN. L. REV. 1197, 1199 (1999) ("The Securities Act of 1933 (Securities Act) [S]ection 8A(a), the Securities Exchange Act of 1934 (Exchange Act) [S]ection 21C(a), the Investment Company Act [S]ection 9(f), and the Investment Advisers Act [S]ection 203(k) provide that the SEC may impose a cease-and-desist order upon any person who 'is violating, has violated, or is about to violate any provision' of the federal securities laws. This plain language—'has violated'—appears to authorize the SEC to base a cease-and-desist order upon a single past violation, without any showing that the violator is likely to break the law in the future.").

132. Suzanne J. Romajas, *The Duty to Disclose Forward-Looking Information: A Look at the Future of MD&A*, 61 FORDHAM L. REV. S245, S286 (1993).

133. 15 U.S.C. § 78u–3(a).

require the business to comply with the provision that was violated,[134] require accounting and disgorgement,[135] and prohibit any person violating any rules or regulations established by the SEC from serving as an officer or director of any issuer that has a class of registered securities.[136]

The SEC may also seek additional disciplinary action by barring issuers from the capital markets.[137] After the SEC finds that a person has engaged in fraudulent acts, an issuer may have its securities delisted to promote equitable trade principles or protect investors.[138] After the Sarbanes-Oxley Act, the SEC may now directly utilize the cease-and-desist proceedings to enforce a suspension or a ban upon demonstrating "some risk" of future misconduct.[139] Moreover, cease-and-desist proceedings permit the SEC to inflict civil penalties upon a company for any violation of the Acts.[140] However, a business is subject to a maximum civil penalty of $500,000 for an SEC regulatory violation.[141]

Although the SEC has broad authority to punish an issuer for its fraudulent actions, under this scenario, an investor's personal remedies are limited and insufficient. The SEC may impose disgorgement damages, but this is insufficient for investors because the SEC rarely wields this weapon in Item 303 administrative actions.[142] Disgorgement damages are analogous to a mighty sword, capable of paralyzing the party at which it aims its swing. However, the sword is useless if you fail to swing it.

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134. *Id.*

135. "In any cease-and-desist proceeding under subsection (a) of this section, the [SEC] may enter an order requiring account and disgorgement, including reasonable interest. The [SEC] is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection." 15 U.S.C. § 78u–3(e). Disgorgement is a remedial power of the SEC to eliminate all gains flowing from acts conducted in violation of SEC Regulations. However, the disgorgement penalty must be casually related to the illicit act, so punitive damages, which can be granted by the courts, may not be granted in fixing a disgorgement amount. *See* SEC v. AMX, Intern., Inc., 872 F. Supp. 1541, 1544 (N.D. Tex. 1994). Furthermore, a Westlaw query shows that disgorgement penalties have only been discussed in 12 Item 303 administrative actions. This illustrates the remedy's ineffectiveness.

136. 15 U.S.C. § 78u–3(f).

137. Smith, *supra* note 131, at 1221.

138. *Id.* at 1224.

139. Edward Greene & Caroline Odorski, *SEC Enforcement in the Financial Sector: Addressing Post-Crisis Criticism*, 16 BUS. L. INT'L 5, 9–10 (2015).

140. 15 U.S.C. § 78u–2.

141. *Id.*

142. *See supra* text accompanying note 135.

Moreover, cease-and-desist actions only require a company to stop prospectively; these actions do nothing to permit an investor to recoup his or her losses retroactively. Although delisting a company appears to be sufficient to deter on its face, it is highly unrealistic to expect this to occur, absent exceptional circumstances. Alternatively, the courts provide the best forum for investors to adequately recover their lost investments.

B. Rule 10b-5 Actions Deter Companies from Omitting Material Forward-Looking Information

Section 10(b) and Rule 10b-5 are designed to serve as the primary private remedies for securities fraud.[143] Rule 10b-5 is much broader than the other rules in Section 10(b), and it may be used as a remedial measure for parties injured as a result of a defendant's deceptive conduct.[144] It is used in the context of insider trading,[145] manipulative conduct,[146] and, most importantly, false SEC filings.[147]

The private cause of action is one that has been generally accepted as implied by Rule 10b-5.[148] To bring a Rule 10b-5 securities fraud class action lawsuit against a registered company, a plaintiff must prove the following: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[149]

In the context of Item 303, the level of materiality required in a 10b-5 action is often disputed. Rule 10b-5 liability for Item 303 omissions hinges on whether Item 303 establishes a duty to disclose.[150] The SEC reads Item 303 as establishing a disclosure duty "where a trend, demand, commitment, event or uncertainty is both [(1)] presently known to management and [(2)] reasonably likely to have material effects on the registrant's financial

143. HAZEN, *supra* note 6, § 12.3(1), at 369.
144. *Id*. § 12.3(3)(B), at 346.
145. *See, e.g.*, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).
146. *See, e.g.*, Chemetron Corp. v. Business Funds, Inc., 718 F.2d 725 (5th Cir. 1983).
147. *See, e.g.*, Ross v. A. H. Robins Co., 607 F.2d 545 (2d Cir. 1979).
148. HAZEN, *supra* note 6, § 12.3(1), at 369.
149. Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008).
150. *See* Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5.").

condition or results of operations."[151] The standard of materiality included in the SEC's 1989 interpretative release is a lower threshold than the Court's standard in *Basic*.[152] That is, less information is required to meet the requirements of materiality for administrative purposes. When faced with the disparities between the SEC's standard and the Court's standard, some courts have found that a disclosure duty is absent from Item 303 for purposes of a Rule 10b-5 action.[153] This rationale is seemingly focused on the Court's higher threshold for materiality.

Two authors have argued that an issuer is subject to a disclosure duty under certain circumstances.[154] Whether a duty to disclose exists will determine if a party violating a disclosure requirement may face a private class action lawsuit under Rule 10b-5.[155] This discussion hinges on the belief that a duty to disclose material information surfaces from "(1) the need to make a periodic filing with the SEC that contains up-to-date information (such as a periodic report, a registration statement for a securities offering, or a proxy statement) [and] (2) a regulatory requirement to disclose certain specific events as they occur."[156]

Periodic reporting obligations pursuant to Sections 13(a) and 15(d) of the Exchange Act require issuers to file periodic reports with the SEC and to provide up-to-date information.[157] These periodic reports, including annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, incorporate the MD&A requirements of Item 303.[158]

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151. *See* Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 43 SEC Docket 1330 (May 24, 1989).

152. *Id.*

153. *See In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1056 (9th Cir. 2014).

154. David M. Stuart & David A. Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 BUS. LAW. 973, 977–78 (2009).

155. *Id.*

156. *Id.*

157. *See id*.

158. Form 10-K is used as a guide by all reporting companies as they engage in annual reporting requirements as required by the securities laws and regulations promulgated by the SEC. *See Form 10-K*, U.S. SEC. AND EXCHANGE COMMISSION, https://www.sec.gov/answers/form10k.htm [https://perma.cc/YJC6-FJWH] (last visited Jan. 1, 2017). Moreover, Form 10-Q is designed to also provide guidance to reporting companies, but unlike Form 10-K, Form 10-Q guides a company in quarterly disclosures. *Id*. Finally, Form 8-K provides reporting guidance to a reporting company after a significant event has occurred. *Id*. That is, unlike Form 10-K and 10-Q, which mandate specific timetables, Form 8-K is only used when a significant event occurs that impacts the company.

Because Item 303 is a line-item regulatory requirement to disclose certain material information, a disclosure duty appears to arise for purposes of a securities fraud private class action lawsuit, as the information is required by a periodic disclosure and regulatory requirement.[159]

Although materiality is critical to a lawsuit proceeding through the courts, there are several other elements of a Rule 10b-5 action that must be satisfied. Scienter is one of the essential elements of a Rule 10b-5 claim, and it has narrowed the abundance of Rule 10b-5 securities class action lawsuits.[160] The Supreme Court first held in the 1970s that the intent of the SEC, when enacting Rule 10b-5, was to govern activities involving scienter.[161] Congress emphasized the Court's scienter findings in the enactment of the Private Securities Litigation Reform Act ("PSLRA")[162] and established a heightened pleading standard.[163] The PSLRA requires an injured party to plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[164] Thus, to bring a Rule 10b-5 action for a material omission of Item 303 information, the plaintiff must prove that the defendant's action of omitting the required information was associated with an intent to deceive, manipulate, or defraud.

A Rule 10b-5 claim also requires a plaintiff to prove a connection between the misrepresentation or omission and the purchase or sale of a security.[165] Additionally, an injured party must show that he or she relied upon the defendant's material misrepresentation or omission.[166] The required causal connection between the plaintiff's injury and the defendant's omission is provided by the element of reliance.[167] The Court has adopted a presumption of reliance through the fraud-on-the-market

159. *See* 17 C.F.R. § 229.303 (2016); *see also* Stuart & Wilson, *supra* note 154, at 977–78.

160. *See, e.g.*, Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008); *Scienter*, BLACK'S LAW DICTIONARY 635 (3d ed. 2006), (defining scienter, in the context of securities fraud, as "a mental state consisting in an intent to deceive, manipulate, or defraud").

161. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976).

162. Securities Exchange Act of 1934, 15 U.S.C. § 78u–4(b) (2012).

163. "In alleging *fraud* or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." FED. R. CIV. P. 9(b) (emphasis added).

164. 15 U.S.C. § 78u–4(b)(2)(A).

165. *Stoneridge Inv. Partners*, 552 U.S. at 157.

166. *Id.*

167. Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988).

theory.[168] That is, in the context of federal securities fraud causes of action, there is a presumption that an investor trading an issuer's shares did so based on the integrity of the stock's value set by the market.[169] Requiring a plaintiff to always establish explicit reliance would be impractical.[170] However, the issuer has the ability to rebut the presumption of reliance or show that it was unreasonable for the investor to rely on the omission.[171] Thus, in the context of Item 303 omissions, an investor need not expressly display reliance on the material omission.

Most importantly, for recovery purposes, the defendant must have suffered economic loss, otherwise known as damages.[172] Correlated to damages, a plaintiff must prove loss causation.[173] Congress has proclaimed that the burden is on the plaintiff to show the causal relationship between his or her damages and the company's fraudulent act or omission.[174] However, the concept of damages is meaningless if the courts hold that an Item 303 omission does not establish an actionable disclosure duty because an injured party would be incapable of recovery in the courts.

Upon satisfying the six procedural requirements of a Rule 10b-5 action, a class of investors should be able to achieve some form of remedy. However, both Section 10(b) and Rule 10b-5 fail to provide explicit provisions explaining the process of determining damages.[175] Courts have applied Section 28 of the Exchange Act's "actual damages" standard[176] to Rule 10b-5 actions.[177] The burden of proof lies with the plaintiff to prove

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168. *Id.* at 244.

169. *Id*.

170. *Id.*

171. HAZEN, *supra* note 6, § 12.4(2), at 383.

172. Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008).

173. *Id.*

174. Securities Exchange Act of 1934, 15 U.S.C. § 78u-4 (2012).

175. *See id.* § 78j; 17 C.F.R. § 240.10b-5 (2016).

176. 15 U.S.C. § 78bb(a)(1) states in full:

> No person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in 1 or more actions, a total amount in excess of the actual damages to that person on account of the act complained of. Except as otherwise specifically provided in this chapter, nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations under this chapter.

177. The correct measure of "actual damages" to be used in a 10b-5 action, under Section 28 formulation, is the fair value of all that the plaintiff received less

his or her "actual damages."[178] Moreover, a plaintiff in a Rule 10b-5 action may be capable of recovering punitive damages.[179] Thus, the judicial remedy for a material omission of forward-looking information is a better alternative than the SEC cease-and-desist authority because not only is the plaintiff able to recover his or her "actual damages," but the court may also deter similar conduct in the future by this issuer through the imposition of punitive damages.

IV. THE SPLIT OVER UNVEILING THE CRYSTAL BALL

Congress granted the SEC cease-and-desist authority to protect against persons committing isolated infractions that present less of a threat to investors,[180] but Congress has noted that injunctive relief by the SEC is not always appropriate and sometimes the courts will need to get involved.[181] Unlike action taken under the SEC's cease-and-desist powers, which merely corrects the issuer's erroneous material omission,[182] a private right of action under Rule 10b-5 inflicts a punishment on the company. However, the courts have failed to reach a consensus on Item 303's role in a private cause of action under the Exchange Act.[183] The Ninth Circuit has held that a material omission of forward-looking information does not impose securities fraud liability, while the Second Circuit, most recently, held that a material omission may impose liability when certain requirements are satisfied.[184] The Supreme

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the fair value of what he could have received absent fraudulent action by the opposing party. Feldman v. Pioneer Petroleum, Inc., 813 F.2d 296, 301 (10th Cir. 1987) (citing Randall v. Loftsgaarden, 478 U.S. 647, 661–62 (1986)).

178. Pelletier v. Stuart-James Co. Inc., 863 F.2d 1550, 1558 (11th Cir. 1989).

179. *See* Bosley v. Special Devices, 130 F. App'x 143, 146 (9th Cir. 2005) (permitting a plaintiff to recover punitive damages in a 10b-5 lawsuit).

180. S. Rep. No. 101-337, at 17 (1990).

181. *Id.* at 14 ("For example, imposition of a civil injunction may result in collateral consequences that are not necessary or appropriate.").

182. While the SEC may impose a maximum $500,000 penalty on a corporation and impose disgorgement damages, these deterrents are insufficient to truly punish the company, because the SEC may not impose punitive damages on a company violating Item 303. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78u-2(b)(3) (2012).

183. Neach, *supra* note 87, at 781.

184. *Compare In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1056 (9th Cir. 2014) ("Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5."), *with* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 100 (2d Cir. 2015) ("[A] failure to make a required Item 303 disclosure . . . is indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim.").

Court's recent denial of certiorari leaves the proper application of Item 303 in a private securities fraud cause unclear.[185]

A. The Third Circuit Introduces the Modern Standard for Liability of Item 303 Omissions

In 2000, the United States Court of Appeals for the Third Circuit addressed liability arising from Item 303 omissions in *Oran v. Stafford* and adopted a modernized standard.[186] *Oran* involved a securities fraud class action lawsuit brought against American Home Products Corporation ("AHP").[187]

At the relevant times, AHP was marketing Pondimin and Redux, weight-loss drugs approved by the Food and Drug Administration ("FDA").[188] In February of 1994, AHP learned that seven patients who had been taking drugs containing Pondimin and Redux began displaying symptoms of leaky heart valves.[189] By November 1995, AHP had knowledge of at least 31 cases of heart valve abnormalities and had received hundreds of adverse reaction reports regarding symptoms often related to heart and lung problems.[190] Only eight of the heart valve cases were reported to the FDA.[191]

The Mayo Clinic reported to AHP that it had a total of 17 patients with heart valve abnormalities in March 1997 and disclosed 24 reports of heart valve abnormalities to the public on July 8, 1997.[192] The Mayo Clinic, the FDA, and AHP all issued public announcements emphasizing that there was no conclusive causal evidence between the symptoms and AHP's drug.[193] These announcements did not have an adverse effect on AHP's stock value.[194]

In mid-September 1997, AHP determined that it would withdraw Pondimin and Redux from the market after a survey revealed that 92 of 291 consumers had developed heart valve abnormalities.[195] Unlike the public statement, this survey was accompanied by a press release

185. *See* Petition for Writ of Certiorari at i, Cohen v. NVIDIA Corp., 135 S. Ct. 2349 (2015) (No. 14-975).

186. Oran v. Stafford, 226 F.3d 275 (3d Cir. 2000).

187. *Id.* at 279.

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.* at 279–80.

193. *Id.* at 280.

194. *Id.*

195. *Id.*

estimating a significant loss of profits.[196] AHP common stock fell over 3% the following day.[197] Shortly thereafter, major publications wrote that AHP had known of possible heart valve abnormalities since at least March 1997, when the Mayo Clinic first informed AHP of the documented heart valve abnormalities.[198] As a result, the AHP stock suffered an additional 4% decline in value.[199]

Plaintiffs alleged that AHP made material misrepresentations and omissions about the safety of its prescription weight-loss drugs while failing to disclose numerous studies that linked the drugs to heart valve damage.[200] The district court noted that the July 1997 data disclosed by AHP was immaterial because there had been full disclosure of the May data without any appreciable effect on AHP's stock value.[201] Moreover, the earlier data from 1994 to 1996 was immaterial because it would not have had a material impact on the substance of the July 8 release.[202] Finally, the district court held that a material omission had not occurred when AHP failed to disclose when it first learned of the adverse health data.[203]

The Third Circuit initially affirmed the district court's conclusion that AHP's failure to disclose data was not a material omission under Rule 10b-5.[204] First, the court had to determine the validity of the plaintiffs' arguments that AHP had an affirmative obligation to disclose the heart valve data's effect on AHP's future prospects under Item 303.[205] The court noted that plaintiffs needed to show that Item 303 provides for an independent cause of action, or that a failure to disclose would constitute a violation of SEC Rule 10b-5.[206]

Applying the Court's materiality definition in *Basic*, the Third Circuit reasoned that a violation of Item 303's reporting requirements, focusing on current operations and management's plans for the future,[207] "does not automatically give rise to a material omission under Rule 10b-5."[208] The

196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.*
200. *Id.* at 279.
201. *Id.* at 281.
202. *Id.*
203. *Id.*
204. *Id.* at 283.
205. *Id.* at 287.
206. *Id.*
207. HAZEN, *supra* note 6, § 9.4(7)(C), at 30.
208. *Oran*, 226 F.3d at 288 (stating that Item 303 is an insufficient avenue for securities fraud liability "[b]ecause plaintiffs have failed to plead any actionable

court reasoned that Rule 10b-5 and Item 303 contain different standards for materiality.[209] In essence, the court established a rebuttable presumption that Item 303 material omissions do not constitute securities fraud. The court's reasoning has been the subject of a recent interpretive debate between the Second and Ninth Circuits.[210]

B. The Ninth Circuit Applied the Oran *Court's Interpretation of Rule 10b-5 as it Relates to Item 303*

Courts have announced varying interpretations of the Third Circuit's holding in *Oran*.[211] In 2008, the Ninth Circuit affirmed a district court's dismissal of a plaintiff's complaint, holding that Item 303 did not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5.[212]

NVIDIA Corporation ("NVIDIA") is a semiconductor company with its core business involving "the design and sale of two similar semiconductor chips": one is a graphics-processing unit ("GPU") and the other is a media and communications processor ("MCP").[213] GPUs and MCPs are both designed to function collaboratively with the products of "original equipment manufacturers ("OEMs"), such as Hewlett-Packard ("HP") and

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misrepresentation or omission under that Rule"). A plain reading of this provision appears to state that Item 303 may provide a basis for liability if the parties sufficiently plead materiality under the probability–magnitude test. *See* 17 C.F.R. § 229.303 (2016).

209. *Oran*, 226 F.3d at 288.

210. *Compare In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1056 (9th Cir. 2014) ("Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5."), *with* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 100 (2d Cir. 2015) ("[A] failure to make a required Item 303 disclosure . . . is indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim.").

211. *Compare NVIDIA Corp. Sec. Litig.*, 768 F.3d at 1054–554, *with* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 103–04 (2d Cir. 2015).

212. *NVIDIA Corp. Sec. Litig*., 768 F.3d at 1056 (indicating that the plaintiff did not adequately prove the scienter element of its claim against the defendant). Both GPUs and MCPs are comprised of "(1) a 'die,' or the silicon chip itself, and (2) a 'substrate,' or wafer, which is a green circuit board that ultimately connects the die to the motherboard's electrical components." The semiconductor chips are manufactured by mounting the die onto the substrate via "bumps" of solder. The bumps are merged to the substrate using a solder paste. An "underfill" separates the die and substrate. This is a "glue-like material" that acts as a supplementary bonding agent to stabilize the die–substrate connection. The solder and underfill, collectively, are referred to as the "Material Set." *Id.* at 1048–49.

213. *Id.* at 1048.

Dell Computer ("Dell")."[214] The processors are incorporated into the motherboards of computers assembled by companies such as HP and Dell, and the finished product is sold to the consumer.[215]

Plaintiffs alleged that NVIDIA began receiving complaints in September 2006 that a number of its semiconductor products were experiencing cracks in the solder bumps when subject to excessive pressure.[216] NVIDIA attempted to resolve the issue by changing the solder paste used to a more malleable compound, but new problems began arising in laptop computers containing NVIDIA's semiconductors.[217] HP and Dell both observed cracking of the solder bumps attaching the die to the substrate.[218] HP discovered that the cause of the problem was a faulty thermal profile that caused stress on the solder bumps, and it shared its findings with NVIDIA.[219] NVIDIA took note of these findings and informed its OEM customers that it would be reverting back to the old solder.[220]

In November 2007, NVIDIA filed a Form 8-K stating that "[its] core businesses are continuing to grow as the GPU becomes increasingly central to today's computing experience."[221] In February 2008, NVIDIA disclosed in its Form 8-K filing that its 2008 fiscal year was a record year and that the demand for GPUs was driving its growth.[222] Finally, in May 2008, NVIDIA disclosed in its Form 10-Q filing that one of its OEMs filed a claim for reimbursement due to an "alleged die/packaging material set defect."[223] NVIDIA's July 2008 Form 8-K filing noted a $150 to $200 million charge to cover costs associated with the die/packaging material set problems.[224] The market reacted to this disclosure, causing NVIDIA's stock value to drop 31%.[225]

A lawsuit arose when purchasers of NVIDIA common stock brought a class action complaint against the corporation for securities fraud.[226] The

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214. *Id.*
215. *Id.*
216. *Id.* at 1049.
217. *Id.*
218. *Id.*
219. *Id.* at 1050.
220. *Id.*
221. *Id.*
222. *Id.*
223. *Id.*
224. *Id.*
225. *Id.* at 1050–51.
226. *See* Class Action Complaint for Violations of the Fed. Sec. Laws, Miller v. NVIDIA Corp., No. 08-4260 (N.D. Cal. Sept. 9, 2008).

investors claimed that NVIDIA knew, but failed to disclose, that prominent "customers . . . were complaining about problems with the company's main products."[227] They contended that, pursuant to Item 303 of Regulation S-K, NVIDIA had a duty to disclose the possibility that the product defects would have substantial financial ramifications on the company.[228] The trial court concluded that the plaintiffs failed to adequately allege scienter—a necessary element for a claim under either Section 10(b) or Rule 10b-5—and dismissed without further leave to amend.[229]

On appeal, the Ninth Circuit held that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5."[230] The court emphasized that Item 303 creates a much broader disclosure duty for management than what *Basic* requires because Item 303 requires disclosure of information "reasonably likely to have a material effect."[231] Ultimately, the court's interpretation of the *Oran* holding was that Item 303 does not create a duty to disclose for purposes of 10b-5.[232] As a result, NVIDIA was not liable for securities fraud under Section 10(b) or Rule 10b-5.[233]

C. The Second Circuit Declines to Follow the Ninth Circuit's Incorrect Interpretation of Oran v. Stafford

The United States Court of Appeals for the Second Circuit took a decidedly different approach than the Ninth Circuit's interpretation of *Oran*.[234] In early 2015, the Second Circuit in *Stratte-McClure v. Morgan Stanley*, affirming the district court's dismissal, held that the plaintiffs' allegations that defendants made material misstatements and omissions to conceal Morgan Stanley's exposure to and losses from the subprime mortgage market did not constitute a violation of Section 10(b).[235]

227. *In re* NVIDIA Corp. Sec. Litig., No. 08-4260, 2011 WL 4831192, at *3 (N.D. Cal. 2011).

228. *Id.*

229. *Id.* at 12.

230. *NVIDIA Corp. Sec. Litig.*, 768 F.3d at 1054 (quoting Basic Inc., 485 U.S. at 239 n.17).

231. *Id.* at 1055 (quoting Management's Discussion and Analysis of Financial Condition and Result of Operations; Certain Investment Company Disclosures, Exchange Act Release No. 26831, 54 Fed. Reg. 22,427, 22,430 n. 27 (May 24, 1989)).

232. *Id.* at 1055–56.

233. *Id.* at 1065.

234. Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 106 (2d Cir. 2015).

235. *Id.* at 108.

Morgan Stanley sparked the lawsuit in December 2006 when it executed a two-component proprietary trade.[236] The trade involved a $2 billion short position and a $13.5 billion long position.[237] The short position involved the acquisition of credit-default swaps[238] and collateralized debt obligations[239] supported by "mezzanine tranches"[240] of subprime residential mortgage-backed securities.[241] Morgan Stanley, through the long position, bought the collateralized debt obligations.[242]

Unfortunately, the housing bubble began bursting in mid-2006, causing delinquencies and defaults on subprime mortgages, like those backing Morgan Stanley's proprietary trade.[243] The effects of the bursting housing bubble caused Morgan Stanley to suffer immense financial losses on its proprietary trade.[244]

Plaintiffs alleged that Morgan Stanley, as well as six of its officers and former officers, made numerous material misstatements and omissions to conceal the effects of Morgan Stanley's subprime proprietary trade.[245] Expounding upon these allegations, the plaintiffs claimed that the fraudulent acts of Morgan Stanley inflated its stock price during the class

236. *Id.*

237. *Id.* at 97.

238. A credit-default swap is "[a]n agreement to purchase a debt in exchange for the seller's promise to compensate the buyer if the debtor defaults." *Credit-Default Swap*, BLACK'S LAW DICTIONARY (10th ed. 2014).

239. A collateralized debt obligation is "[a] structured financial product that pools together cash flow-generating assets and repackages this asset pool into discrete tranches that can be sold to investors." *See Collateralized Debt Obligation*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/c/cdo.asp [https://perma.cc/2R7G-2KZH] (last visited Oct. 2, 2016).

240. A mezzanine tranche is a pool of the cash flows streaming from collateralized debt obligations that generally carry "AA" to "BB" credit ratings. *See CDO Mortgages*, INVESTOPEDIA.COM, http://www.investopedia.com/articles/07/cdo-mortgages.asp [https://perma.cc/JJ68-YQEG] (last visited Oct. 2, 2016).

241. *Stratte-McClure*, 776 F.3d at 96. A residential mortgage-backed security is "a type of mortgage-backed debt obligation whose cash flows come from residential debt" and serves as the foundation for instruments such as collateralized mortgage obligations. Residential mortgage-backed securities are considered to be a key factor in the 2008 financial crisis. *See Residential Mortgage-Backed Security*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/r/rmbs.asp [https://perma.cc/C5AM-9KQL] (last visited Oct. 2, 2016).

242. *Stratte-McClure*, 776 F.3d at 97.

243. *Id.*

244. *Id.* In fact, Morgan Stanley lost billions of dollars because of the proprietary trade. *Id.* at 97.

245. *Id.* at 96.

period and caused the plaintiffs to suffer financial loss when the market learned the truth about Morgan Stanley's proprietary trade losses.[246]

Observing that its judgment was adverse to the Ninth Circuit's opinion in *NVIDIA*,[247] the Second Circuit held that "a failure to make a required Item 303 disclosure . . . is indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim . . . if it satisfies the materiality requirements outlined in [*Basic*]."[248] This added to the court's previous discussion of Item 303, in which it held that the omission of "known trends or uncertainties from a registration statement or prospectus is actionable under Sections 11 and 12(a)(2) of the Securities Act of 1933."[249] The court reasoned that a quarterly filing, which includes Item 303 disclosures, is similar to registration statements and prospectuses.[250]

An omission from an Item 303 disclosure would lead a reasonable investor to infer that "known trends or uncertainties . . . that the registrant reasonably expects will have a material . . . unfavorable impact on . . . revenues or income from continuing operations" are nonexistent.[251] Furthermore, the court noted that the Ninth Circuit incorrectly interpreted the Third Circuit's conclusion in *Oran* by finding that "Item 303 violations are never actionable under Rule 10b-5."[252] Conversely, a proper interpretation of *Oran* suggests the possibility that a violation of Item 303 could give rise to liability under Rule 10b-5.[253] A material omission from Item 303, thus, may give rise to liability under Section 10(b) and Rule 10b-5 because Item 303 imposes a duty to speak.[254] The Second Circuit nonetheless proceeded to affirm the district court's dismissal of the plaintiffs' exposure claim because the complaint failed to properly plead scienter.[255] Unfortunately, the United States Supreme Court, in March of 2015, left the conflict unresolved when it denied a petition for certiorari seeking to determine whether the Ninth Circuit or the Second Circuit correctly interpreted the law.[256] However, all lower courts should adopt

246. *Id.*
247. *Id.* at 103 ("We note that our conclusion is at odds with the Ninth Circuit's recent opinion in [*NVIDIA*].").
248. *Id.* at 100.
249. *Id.* at 101.
250. *Id.* at 102.
251. *Id.* (quoting 17 C.F.R. § 229.303(a)(3)(ii) (2016)).
252. *Id*. at 103.
253. *Id.*
254. *Id.*
255. *Id.*
256. *See* Petition for Writ of Certiorari, Cohen v. NVIDIA Corp., 135 S. Ct. 2349 (2015) (No. 14-975) (declining to resolve "[w]hether Item 303 of Regulation

the Second Circuit's approach because the philosophy of full disclosure outweighs the limited remedies available to an injured investor through the SEC.

V. FAILURE TO UNVEIL THE CRYSTAL BALL SHOULD IMPOSE SECURITIES FRAUD LIABILITY

The Exchange Act does not explicitly provide for a private right of action to enforce Section 10(b) and the rules and regulations promulgated thereunder.[257] Accordingly, it may appear that the spirit of the Exchange Act was to provide a publicly administered enforcement regime, as opposed to a privately administrated enforcement regime. Resorting to this sort of interpretation would lead to inequitable results and would continue to enlarge the issues arising under management's disclosure of forward-looking information.

Given that the core purpose of the Exchange Act is to implement a philosophy of full disclosure,[258] investors negatively impacted by issuers' fraudulent material omissions should have an action under Section 10(b) and Rule 10b-5. To do otherwise would run contrary to the spirit of the Exchange Act. Failure to impose Rule 10b-5 liability for an issuer's choice to withhold material forward-looking information promotes a less efficient market and hurts investors by denying them access to valuable information when making their investment decisions.[259] The investor's interest in receiving the information should outweigh a company's interest in withholding the information.

Absent a disclosure duty, a company's omissions are not misleading as to Rule 10b-5 liability.[260] That is, a disclosure duty is not established solely by the possession of material, non-public information.[261] But, there

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S-K forms the basis for a duty to disclose otherwise material information for purposes of an omission actionable under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 as the Second Circuit recently held in direct conflict with the Ninth Circuit's holding in this case").

257. *See* Stoneridge Inv. Partners, LLC, v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008).

258. *See* Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) ("This Court 'repeatedly has described the "fundamental purpose" of the Act as implementing a "philosophy of full disclosure."'") (quoting Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477–78 (1977)); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

259. Romajas, *supra* note 132, at S247.

260. *See Basic*, 485 U.S. at 239 n.17.

261. Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1202 (1st Cir. 1996).

is an affirmative duty to disclose material, forward-looking information for purposes of nondisclosures under Section 11 of the Securities Act.[262] Circuits have found that an omission of known trends or uncertainties from a registration statement or prospectus is actionable under the Securities Act.[263] Logically, a material omission of Item 303 should provide a similar action for periodic disclosures under the Exchange Act. In essence, Item 303 should include a *per se* duty to disclose.

The Exchange Act, unlike the Securities Act, regulates the disclosure of information vis-à-vis periodic disclosure forms. The per se duty to disclose, for purposes of a Rule 10b-5 class action securities fraud lawsuit, arises because the issuer has a regulated responsibility to provide the SEC with up-to-date information.[264] Although the general rule is that silence, absent a duty to disclose, is not misleading, this rule is inapposite to Item 303 because the regulatory provisions establish a duty to disclose. Accordingly, a material omission of Item 303 is misleading because there is a disclosure duty impounded upon the issuer.

An omission rendered "material" under the Court's standard of materiality for speculative information[265] should be applied in the context of a private securities fraud action pursuant to an Item 303 omission. A cease-and-desist action by the SEC is not as powerful of a deterrent as a financial punishment for misconduct, so it is necessary to establish alternative means of deterrence for material Item 303 omissions.[266] Although the SEC's materiality standard for Item 303 does differ from the Court's materiality standard,[267] the SEC's standard should only apply for agency administration actions. For example, the SEC should have broad authority to impose its cease-and-desist sanctions that prevent a company from continuing to violate federal securities laws or from engaging in a potential violation of the law. This does not account for the investors who

262. *Id.*

263. *See* Panther Partners Inc. v. Ikanos Commc'ns, Inc., 681 F.3d 114, 120 (2d Cir. 2012); *see also* Silverstrand Invs. v. AMAG Pharm., Inc., 707 F.3d 95, 102 (1st Cir. 2013) ("As Plaintiffs correctly point out, an actionable § 11 omission may arise when a registration statement fails to comply with Item 303 or 503 of SEC Regulation S–K.").

264. *See* Stuart & Wilson, *supra* note 154, at 977–78.

265. *See Basic*, 485 U.S. at 238–39.

266. *See* Greene & Odorski, *supra* note 139, at 6.

267. *Compare* Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22,427 (May 18, 1989), *with Basic*, 485 U.S. at 238–39.

may have suffered financial losses.[268] Although the SEC retains the power to impose disgorgement damages, this is an ineffective tool because it has only been wielded a handful of times in the context of an Item 303 administrative action.[269] Moreover, the SEC lacks the ability to impose the purest form of deterrent—punitive damages.[270] For Rule 10b-5 claims, such as those in *Morgan Stanley*, *NVIDIA*, and *Oran*, the courts should be permitted to impose liability for securities fraud in favor of a class of injured investors.[271]

Permitting courts to impose liability does not mean that an abundance of Rule 10b-5 claims for material MD&A omissions are going to arise and succeed.[272] The threshold to bring a Rule 10b-5 action remains high. Not only must plaintiffs prove a material omission, but they must also prove scienter; a connection between the misrepresentation or omission and the purchase or sale of a security; reliance; economic loss; and loss causation.[273] As displayed in the illustrative cases, the claims are often disposed of for failure to satisfy the scienter requirement.[274] The theory being proposed may in fact increase the quantity of securities fraud

268. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78u-2(b)(3) (2012) ("[T]he maximum amount of penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person.").

269. *See id*. § 78u–3(e).

270. *See* SEC v. AMX, Intern., Inc., 872 F. Supp. 1541, 1544 (N.D. Tex. 1994).

271. When Congress enacted the Securities Acts, the "reasonable" investor was believed to be the retail investor, but times have changed. Now, sophisticated, institutional investors, as opposed to retail investors, constitute the bulk of investors. These institutional investors may not need the same protections that Congress sought to provide as a result of their immense knowledge. However, this disputed issue is not the focus of this comment. For more information on this ongoing debate see Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. REV. 461, 518 (2015).

272. *See cf. In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 263 (2d Cir. 1993) ("[T]here is the interest in deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal, even though no recovery would occur if the suit were litigated to completion.").

273. Stoneridge Inv. Partners, LLC, v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008).

274. *See In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1048 (9th Cir. 2014), *cert. denied*, 135 S. Ct. 2349 (2015) (holding that the district court properly dismissed the case by holding that the plaintiffs' amended complaint failed to adequately allege scienter); Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 100 (2d Cir. 2015) (affirming the district court's dismissal of the plaintiffs' claim that the defendants' omissions violated Section 10(b) and Rule 10b-5 because the second amended complaint did not give rise to a strong inference of scienter).

litigation in federal district courts. While more litigation may arise, and many of these cases being dismissed for failure to satisfy the scienter requirement, the overarching policy of disclosure undoubtedly trumps the risk of vexatious litigation.

Moreover, the issuers are very likely to be protected by the safe harbor provisions when they elect to disclose material forward-looking information. The safe harbor rules are designed "to encourage the voluntary disclosure of forward-looking information by removing the deterrent of liability for making such disclosures."[275] The instructions to Item 303 provide that "[a]ny forward-looking information supplied is expressly covered by the safe harbor rule for projections[,]" including Rule 175.[276] Rule 175 shields issuers from securities fraud liability when the qualifying forward-looking information is grounded in a reasonable basis and is disclosed in good faith.[277] The SEC's safe harbor rule for projections also excludes false forward-looking statements from securities fraud liability, as long as it was issued with a reasonable basis and in good faith.[278] Moreover, a long line of cases has established a common law safe harbor known as the "bespeaks caution" doctrine.[279] This renders material information immaterial as a matter of law when the forward-looking statements are accompanied by meaningful cautionary statements that do not affect the "total mix" of information provided to the investor.[280] Absent proper disclosure, however, these safeguards are inapplicable to a party trying to defeat a securities fraud lawsuit.[281]

Therefore, the standard enumerated in *Morgan Stanley* should be adopted when a company fails to comply with Item 303 in a periodic disclosure. Rule 10b-5 liability must arise when an omission of speculative, forward-looking information is material under *Basic* and the other elements of Rule 10b-5 have been established.[282]

CONCLUSION

Investors should have the ability to unveil a securities issuer's "crystal ball." That is, investors should have access to all material forward-looking

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275. Romajas, *supra* note 132, at S252.
276. 17 C.F.R. § 229.303 (2016).
277. *Id*. § 230.175.
278. Safe Harbor Rule for Projections, Securities Act Release No. 532, 1979 WL 181199 (June 25, 1979).
279. *See In re* Donald J. Trump Casino Sec. Litig.–Taj Mahal Litig., 7 F.3d 357, 371 (3d Cir. 1993) (listing cases that apply the bespeaks caution doctrine).
280. *Id.*
281. Neach, *supra* note 87, at 744–45.
282. *See* Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 103–04 (2d Cir. 2015).

information at management's disposal. Recently, a federal circuit split arose on this exact controversy. The circuits dispute whether Item 303 imposes a disclosure duty upon a federal securities issuer. This determination is critical to investors seeking to bring a federal securities fraud claim for an omission of material forward-looking information because absent a duty to disclose, an omission is not misleading under Rule 10b-5. Issuers should be held liable for federal securities fraud when their actions fraudulently run contrary to the clear intent of federal securities laws because Item 303 indeed imposes a disclosure duty upon an issuer. Barring investors from bringing a lawsuit for such an omission runs contrary to Congress's intent to implement full disclosure and the SEC's intent to permit an investor to look through the eyes of management.

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