A Call for the SEC to Adopt More Safe Harbors that Limit the Reach of Rule 10b-5

*By Allan Horwich**

The SEC has often adopted regulations that describe conduct that is deemed not to violate the law or that effectively exclude specified conduct from the scope of particular provisions of the securities laws, such as the prohibition on deception imposed by SEC Rule 10b-5. This article examines the nature of and rationales for the provisions that have narrowed the reach of that rule, and proposes that this approach be applied more broadly, further reducing the exposure of issuers of securities and other persons to claims under Rule 10b-5 without impairing the SEC's enforcement of the securities laws. This will reduce uncertainty regarding the scope of Rule 10b-5, including in the arena of private damage claims, directing the focus to misrepresentations and half-truths. Several specific proposals are made here. The intention is to focus attention on the utility of the safe harbor approach in today's litigation landscape and generate discussion that might lead to broader application of this concept.

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I. Introduction

The U.S. Securities and Exchange Commission ("SEC") has often adopted regulations that describe conduct that is deemed not to violate the law or that effectively exclude specified conduct from the scope of particular provisions of the securities laws, such as the prohibition on deception imposed by SEC Rule 10b-5.[1] This article examines the nature of and rationales for the provisions that have narrowed the reach of that rule, and proposes that this approach be applied more broadly, further reducing the exposure of issuers of securities and other persons to claims under Rule 10b-5 without impairing the SEC's enforcement of the securities laws. This will reduce uncertainty regarding the scope of Rule 10b-5, including in the arena of private damage claims, directing the focus to misrepresentations and half-truths. Several specific proposals are made here. The intention is to focus attention on the utility of the safe harbor approach in today's litigation landscape and generate discussion that might lead to broader application of this concept.

The proposals made here parallel actions the SEC has already taken to remove failures to file certain reports from the scope of Rule 10b-5, sometimes called pure omissions. This approach may seem to be of limited utility because claims based on pure omissions that would be excluded as a result of the proposed additional safe harbors may be few and far between.[2] However, because the SEC has

1. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2018), was adopted by the SEC in 1942 pursuant to authority granted in section 10(b) of the Exchange Act. 15 U.S.C. § 78j(b) (2018). Rule 10b-5 is discussed in more detail in Part III of this article.

2. *See, e.g.*, *infra* text accompanying notes 137–39 (discussing that claims based on a complete failure to disclose are likely to be rare).

seen fit to adopt rules that exclude disclosure failures from the scope of Rule 10b-5[3] based on its view that a complete failure to comply can give rise to a Rule 10b-5 claim,[4] other mandatory disclosure regulations merit comparable protections. Unless and until the U.S. Supreme Court rules that a failure to file is outside the ever-narrowing bounds of Rule 10b-5,[5] the proposals advanced here deserve serious consideration, if only to sweep away the chaff.

These proposals do not advocate that the SEC make a sweeping effort to decimate the Rule 10b-5 private cause of action by fiat. Rather, it is a modest suggestion, consistent with rules the SEC has already adopted, to limit the reach of Rule 10b-5 in a narrow category, with the intent of focusing claims on established areas of liability.

Part II of this article explains what safe harbors are. Part III describes, in general terms, the scope of Rule 10b-5, in particular how the rule has been applied in private damage actions alleging the failure to make a required disclosure. Part IV describes safe harbors that have a direct impact on potential claims under Rule 10b-5, including the background of each rule. Part V presents specific suggestions for additional safe harbors vis-à-vis Rule 10b-5 with supporting analysis. Part VI is the conclusion.

II. The Concept of the Safe Harbor

The SEC has extensive rulemaking power under the Securities Act of 1933 ("Securities Act")[6] and the Securities Exchange Act of 1934 ("Exchange Act").[7] For example, it has the power to define terms used in each statute.[8] It has the power to exclude certain transactions from the scope of the registration provisions of state securities laws.[9] The SEC has used these and other grants of authority to adopt rules that define terms with greater precision than expressed in the statutes, so that participants in the market, including issuers of securities,[10] have greater certainty regarding whether their conduct complies with the law. The term "safe harbor" is most closely associated with SEC rules that

3. *See infra* Parts IV.B, D (discussing the safe harbors that the SEC has adopted that exclude a complete failure of disclosure from the scope of Rule 10b-5).

4. *See, e.g.*, *infra* text accompanying notes 104–06 & 119–30 (discussing the SEC's stated rationale for the Rule 10b-5 safe harbors).

5. *See infra* text accompanying notes 29–31 (discussing the trend in recent Supreme Court decisions to narrow the scope of the private damage action based on Rule 10b-5).

6. 15 U.S.C. §§ 77a–77z-3 (2018).

7. *Id.* §§ 78a–78pp.

8. Securities Act § 19(a), 15 U.S.C. § 77s(a); Exchange Act § 23(a)(1), 15 U.S.C. § 78v(a)(1).

9. *See* Securities Act § 18(a), 15 U.S.C. § 77r(a) (providing for the exclusion from the reach of state law registration provisions of "covered securities" where "[a] security is a covered security with respect to the offer or sale of the security to qualified purchasers, as defined by the Commission by rule").

10. This article addresses primarily though not exclusively issues pertaining to companies that are subject to the Exchange Act reporting requirements. These are entities with a class of securities registered under section 12(b) or 12(g) of the Exchange Act (15 U.S.C. §§ 78*l*(b), (g)) and entities that complete the registration process in compliance with section 5 of the Securities Act (15 U.S.C. § 77e) for the public offering of securities, which report in accordance with section 15(d) of the Exchange Act (15 U.S.C. § 78o).

provide a roadmap for compliance with a specific statutory requirement or avoidance of what otherwise might be a violation of a statutory provision.[11] This article uses the term "safe harbor" more broadly to encompass rules of those types as well as rules that specify that defined conduct is not a *per se* violation of the law, particularly Rule 10b-5.

Securities Act Rule 169 is one example of a safe harbor that provides that if a person takes certain steps and avoids other action its conduct will be deemed compliant with the law.[12] This rule sets forth the conditions for a company that is in the process of preparing to commence its initial public offering of securities to communicate, in the ordinary course of business, factual information that is deemed, by the rule, not to constitute an "offer to sell" a security, and thus not in violation of section 5(c) of the Securities Act, which prohibits offers of securities before a registration statement has been filed with the SEC.[13] Rule 506(b), an example of the other common type of safe harbor, sets forth requirements which, if satisfied, are deemed to effect compliance with the section 4(a)(2) statutory exemption from registration.[14] The flexibility in the application of the standards under section 4(a)(2) "for issuers, business people, and attorneys . . . is a cause of anxiety and frustration. . . . Rule 506 of Regulation D attempts to bring more certainty to the private placement area."[15]

As discussed in Part IV, the SEC has adopted a third type of safe harbor, addressing the scope of Rule 10b-5. These provide that the failure to file certain required reports with the SEC is not a *per se* violation of that rule.

III. The Scope and Application of Rule 10b-5

A. An Overview of Rule 10b-5

The following summary provides the fundamentals of the law applying Rule 10b-5 to give sufficient background to consider the issue addressed in the cases that suggest there is a need for the expansion of safe harbors applicable to Rule 10b-5, the principal antifraud rule in the SEC enforcement arsenal.[16] The rule provides, in its entirety:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

11. A "safe harbor" is "[a] provision (as in a statute or regulation) that affords protection from liability or penalty." *Safe Harbor*, Black's Law Dictionary (10th ed. 2014).

12. 17 C.F.R. § 230.169 (2018).

13. 15 U.S.C. § 77e(c) (2018).

14. Securities Act § 4(a)(2), 15 U.S.C. § 77d(a)(2) (2018) (exempting "transactions by an issuer not involving any public offering"); Securities Act Rule 506(b), 17 C.F.R. § 230.506(b) (2018). *See infra* Part V.E.

15. 7A J. William Hicks, Exempted Transactions Under the Securities Act of 1933 § 11.3 (2018).

16. *See* Donna M. Nagy, Richard Painter & Margaret V. Sachs, Securities Litigation and Enforcement Cases and Materials 25 (4th ed. 2017) ("Rule 10b-5 is the leading anti-fraud weapon in the federal securities laws."). For a comprehensive discussion of the elements of the Rule 10b-5 cause of action, see *id.* ch. 2.

(a) To employ any device, scheme, or artifice to defraud,

(b) To 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, or

(c) To 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.[17]

The Supreme Court has long recognized the validity of an implied private cause of action for a violation of Rule 10b-5,[18] subject to judicial determination of the contours of the cause of action[19] as well as congressional action affecting both the pleading and substantive requirements for maintaining a Rule 10b-5 private damage claim.[20]

In order to establish an enforcement claim in violation of Rule 10b-5, the SEC must prove that there has been prohibited conduct with scienter in connection with the purchase or sale of securities.[21] Scienter "refers to a mental state embracing intent to deceive, manipulate, or defraud."[22] The courts of appeals have uniformly held that under Rule 10b-5 scienter includes reckless conduct.[23] Additional elements, reliance upon the deception, loss causation, and damages, must be proven to establish a private claim for damages.[24]

Rule 10b-5 has become a powerful tool in the hands of investors, or perhaps more accurately their counsel, especially when a Rule 10b-5 claim can be pursued on behalf of a class of investors under Rule 23 of the Federal Rules of

17. 17 C.F.R. § 240.10b-5 (2018).

18. *See, e.g.*, Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("a private right of action under Section 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure.").

19. *See, e.g.*, Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 141–43 (2011) (holding that the word "make" in Rule 10b-5(b) limits liability to "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it").

20. *See, e.g.*, Private Securities Litigation Reform Act ("PSLRA"), Pub. L. No. 104-67, § 101(b), 109 Stat. 737, 743–49 (1995) (codified as amended at 15 U.S.C. § 78u-4 (2018)) (Exchange Act § 21D). Section 21D imposes a variety of requirements on private damage claims under Rule 10b-5, including class actions.

21. SEC v. Wolfson, 539 F.3d 1249, 1256 (10th Cir. 2008). Rule 10b-5 also reaches manipulative conduct, a topic that is beyond the scope of this article except for the brief discussion of the safe harbor in Rule 10b-18. *See infra* Part IV.A. In the context of section 10(b) manipulation "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

22. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1975).

23. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) ("Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required."). This question has been repeatedly reserved by the Supreme Court. Most recently see Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 29 (2011).

24. Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc., 552 U.S. 148, 157 (2008) ("In a typical § 10(b) private action a plaintiff must prove (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.").

Civil Procedure. Rule 10b-5 class actions, which can result in recoveries in the billions of dollars,[25] have their supporters[26] and detractors.[27]

Early on the Supreme Court recognized the value of the Rule 10b-5 private damage claim as an enhancement of the SEC enforcement agenda.[28] It was not long, however, before the Court became concerned about the effects of the Rule 10b-5 private damage action, taking note, albeit without citation, of the "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[29] In recent years the Court has narrowed the application of the rule both by specifying what must be proven[30] and by interpreting the words of the rule.[31] Because the cause of action has been implied by the courts, they are the master of the elements of the claim, except where Congress has spoken.[32] While the Supreme Court has often declined to accept the SEC's arguments on the elements of the private cause of action under Rule 10b-5,[33] the SEC retains the power to modify the rule.[34]

25. *See* ISS SEC. CLASS ACTION SERVS., THE TOP 100 U.S. CLASS ACTION SETTLEMENTS OF ALL TIME 6–17 (2018), https://www.issgovernance.com/file/publications/SCAS-Top-100-US-Settlements-2017.pdf?elqTrackId=a1bca66ee21241efbf156ad0779a9c14&elq=4efc545b0f6c4b219bf0aa904c7f8c50&elqaid=556&elqat=1&elqCampaignId= (listing thirteen settlements in excess of $1 billion).

26. *See, e.g.*, James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 524 (1997) ("reform of class actions may not require more than an awakening within the judiciary that it is its duty to make the class action virtuous"); Arthur R. Miller, *The Preservation and Rejuvenation of Aggregate Litigation: A Systematic Imperative*, 64 EMORY L.J. 293, 326 (2014) ("I simply cannot envision a litigation world devoid of procedural mechanisms for the group adjudication of claims.").

27. *See, e.g.*, U.S. CHAMBER INST. FOR LEGAL REFORM, WHAT'S WRONG WITH SECURITIES CLASS ACTION LAWSUITS 2 (Feb. 2, 2014), http://www.instituteforlegalreform.com/uploads/sites/1/Securities_Class_Actions_Final1.pdf (commenting on "the irrationality and ineffectiveness" of the securities class action, and "the fact that securities litigation continues to be driven and controlled by plaintiffs' lawyers," among other criticisms).

28. *See* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) ("we repeatedly have emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action'" (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964))).

29. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975).

30. *See, e.g.*, Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc., 552 U.S. 148, 166–67 (2008) (holding that investors could not satisfy the necessary element of reliance where they were not aware at the time of their investment of the involvement in the alleged scheme of the defendants).

31. *See, e.g.*, Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142–48 (2011), *discussed in supra* note 19.

32. *See, e.g.*, NAGY ET AL., *supra* note 16, at 26–28 (discussing in general terms the judicial interpretation of Rule 10b-5); PSLRA, *supra* note 20 (enacting statutory provisions affecting some aspects of private damage claims under Rule 10b-5).

33. *See Janus*, 564 U.S. at 145 n.8 ("We . . . have previously expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action. . . . This also is not the first time this Court has disagreed with the SEC's broad view of § 10(b) or Rule 10b-5." (citations omitted)).

34. *See infra* Part V.H (addressing the validity of the safe harbor rules proposed in this article).

B. The Rule 10b-5 "Duty to Disclose" Cases Regarding Regulation S-K Item 303

One issue regarding liability under Rule 10b-5 that has not been resolved by the Supreme Court[35] is whether a Rule 10b-5 claim can be based on a defendant's alleged complete failure to comply with an SEC mandatory disclosure requirement. That is, is the failure to make a required material public disclosure a deceptive act that violates the rule?

The SEC has imposed many disclosure requirements as part of the Exchange Act mandatory disclosure regime for public reporting companies.[36] Most Rule 10b-5 claims arise under clause (b) of the rule. A literal application of this subsection reaches only an affirmative false statement or a statement that is materially incomplete, sometimes called a half-truth.[37] "Silence, absent a duty to disclose, is not misleading under Rule 10b-5."[38] This presents the question whether the total failure to satisfy an Exchange Act mandatory disclosure requirement is silence that violates one of the other two clauses of Rule 10b-5. Clauses (a) and (c) respectively prohibit "any device, scheme, or artifice to defraud" and "any act, practice, or course of business which operates or would operate as a fraud or deceit."

There is an apparent split among the circuits on this issue.[39] Following is a summary of the rulings in the four pertinent decisions by the courts of appeals, the Third Circuit in *Oran v. Stafford*,[40] the Ninth Circuit in *In re NVIDIA Corp. Securities Litigation*,[41] and the Second Circuit in *Stratte-McClure v. Morgan Stanley Corp.*[42] and *Indiana Public Retirement System v. SAIC, Inc*.[43] The purpose of this article is not to resolve whether Rule 10b-5 reaches a complete failure to comply

35. As discussed later (*see infra* text accompanying notes 81–82), this issue was before the Court in the October 2017 Term, but the case was settled before oral argument.

36. *See, e.g.*, Rules 13a-1, 13a-11, 13a-13, 17 C.F.R. §§ 240.13a-1, -11, -13 (2018) (requiring filing of Forms 10-K, 8-K, and 10-Q, respectively, for companies with a class of securities registered pursuant to section 12 of the Exchange Act).

37. James D. Cox, Robert W. Hillman & Donald C. Langevoort, Securities Regulation Cases and Materials 722–23 (8th ed. 2017) (stating that the half-truth concept, which imposes a duty to speak completely when making a voluntary statement, "does not prohibit total silence"). The half-truth is a "statement that is literally true but omits some material fact, thereby making it misleading." Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 Stan. L. Rev. 87, 88 (1999).

38. Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988).

39. In a thorough examination of the issues presented by the cases discussed below, former SEC Commissioner, now Professor, Joseph Grundfest, questioned whether the "split" is "semantic or substantive." *See* Joseph A. Grundfest, *Ask Me No Questions and I Will Tell You No Lies: The Insignificance of* Leidos *Before the United States Supreme Court* 4 (Rock Ctr. for Corp. Governance Working Paper Series No. 229, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3043990&download=yes.

40. 226 F.3d 275 (3d Cir. 2000) (Alito, J.).

41. 768 F.3d 1046 (9th Cir. 2014).

42. 776 F.3d 94 (2d Cir. 2015). The court dealt with other issues on appeal in a separate opinion. *See* Stratte–McClure v. Morgan Stanley, Corp., 598 F. App'x 25 (2d Cir. 2015) (affirming the dismissal of aspects of the complaint).

43. 818 F.3d 85 (2d Cir. 2016), *cert. granted sub nom.* Leidos, Inc. v. Ind. Pub. Ret. Sys., 137 S. Ct. 1395 (2017) (No. 16-581), *cert. dismissed*, 138 S. Ct. 2670 (2018).

with an SEC mandatory disclosure requirement.[44] What follows establishes the uncertainty about the scope of Rule 10b-5 in this respect, providing the foundation for proposals to adopt rules that would eliminate this basis of liability in some circumstances, causing litigants and courts to focus on misrepresentations and half-truths.

1. Regulation S-K Item 303

Each of the cases arose out of a claim that Regulation S-K Item 303 was not satisfied. In the Form 10-K required annual report of a public reporting company,[45] the company must comply with the following directive.

> Describe 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. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed.[46]

Generally under the federal securities laws a fact that is omitted is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding whether to buy or sell securities; "there must be 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."[47] "[W]ith respect to contingent or speculative information or events . . . materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"[48]

The SEC has instructed companies to engage in a two-prong test when complying with the MD&A known trend disclosure requirement:

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44. For analyses of the question presented to the Court, see the briefs filed in that case, https://www.americanbar.org/groups/public_education/publications/preview_home/2017_2018_briefs/16-581.html. Extensive analysis is also presented in Grundfest, *supra* note 39 (arguing that the case should be decided for the defendants); Matthew C. Turk & Karen E. Woody, *The* Leidos *Mixup and the Misunderstood Duty to Disclose in Securities Law* (Kelly Sch. of Bus. Research Paper 2017-44, 2017), https://papers.ssrn.com/sol3/results.cfm (arguing for the recognition of liability under Rule 10b-5 for noncompliance with a disclosure mandate in some circumstances).

45. Item 7 of Part II of the annual report on Form 10-K (https://www.sec.gov/files/form10-k.pdf) requires compliance with Regulation S-K Item 303, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). Item 303(a) is applicable to full fiscal years. 17 C.F.R. § 229.303(a) (2018).

Item 2 of Part I of the quarterly report on Form 10-Q (https://www.sec.gov/files/form10-q.pdf) also requires compliance with Item 303. For interim periods, Item 303(b) directs the reporting company to "include a discussion of material changes in those items specifically listed in paragraph (a) of this Item, except that the impact of inflation and changing prices on operations for interim periods need not be addressed." *Id.* § 229.303(b).

46. Regulation S-K, Item 303(a)(3)(ii), 17 C.F.R. § 229.303(a)(3)(ii).

47. Basic Inc. v. Levinson. 485 U.S. 224, 231–32 (1988).

48. *Id.* at 239 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

(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 is 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.[49]

The SEC has emphasized that this standard is not the same as the core test of materiality under the federal securities laws:

> MD&A mandates disclosure of specified forward-looking information, and specifies its own standard for disclosure—i.e., reasonably likely to have a material effect. This specific standard governs the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved [in *Basic Inc. v. Levinson*] is inapposite to Item 303 disclosure.[50]

Each of the four cases described below involved a claim that the breach of a duty to disclose allegedly required by Item 303 supported a cause of action under Rule 10b-5.

2. *Oran*

In *Oran* the plaintiffs argued that the corporate defendant had an affirmative obligation under Item 303 to disclose the impact of certain material product-related information on the company's future prospects.[51] After first holding that a violation of Item 303 does not give rise to an independent implied private right of action,[52] the court addressed whether Item 303 created a duty to disclose that would, if breached, give rise to liability under Rule 10b-5. In evaluating this argument, the court agreed with the SEC that the SEC two-part test to determine whether information must be disclosed "varies considerably from the general test for securities fraud materiality set out by the Supreme Court in [*Basic*]."[53] Consequently, a failure to comply with Item 303 "does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5. Such a duty to disclose must be separately shown."[54] Therefore, the court held, a violation of the Item 303 "reporting requirements does not

49. SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6,835, 54 Fed. Reg. 22427, 22430 (May 24, 1989).

50. *Id.* at 22430 n.27.

51. Oran v. Stafford, 226 F.3d 275, 287 (3d Cir. 2000).

52. *Id.* ("neither the language of the regulation nor the SEC's interpretative releases construing it suggest that it was intended to establish a private cause of action").

53. *Id.* at 288.

54. *Id.* (quoting Alfus v. Pyramid Tech. Corp., 764 F. Supp. 598, 608 (N.D. Cal. 1991)).

automatically give rise to a material omission under Rule 10b-5."[55] Because the plaintiffs had not alleged any material deception in violation of Rule 10b-5 or in noncompliance with Item 303,[56] the court's ruling was not a definitive rejection of basing a Rule 10b-5 claim on a *material* noncompliance with Item 303.[57]

3. *NVIDIA*

The claim in *NVIDIA* arose out of what the plaintiffs contended were belated disclosures of anticipated charges to cover costs arising from product defects. Plaintiffs argued that NVIDIA knew of the defects long before it disclosed them, that this knowledge was material to investors, and that the failure to disclose the information made other statements in NVIDIA's SEC filings misleading.[58] The district court dismissed the plaintiffs' complaint, holding that it failed adequately to allege scienter.[59] On appeal, the plaintiffs argued that the district court erred by failing to consider their allegations of scienter in the context of Item 303, contending that if the information was material, there was a failure to disclose that would constitute a material omission for purposes of Rule 10b-5.[60]

The court of appeals held that Item 303 does not create a disclosure duty actionable under Rule 10b-5, citing *Oran*[61] and observing that a company's duty to disclose under Item 303 is "much broader than what is required under the standard pronounced in *Basic*."[62] The court noted that Rule 10b-5 does not contain any language imposing liability based on "omit[ting] to state a material fact required to be stated."[63] Here the court drew a contrast with section 11 of the Securities Act,[64] which imposes liability where a registration statement for a public offering "omitted to state a material fact required to be stated therein."[65] Under Rule 10b-5, "material information need not be disclosed unless omission of that information would cause other information that is disclosed to be misleading."[66] In other words, the only basis for liability for omitting a disclosure required by Item 303 is where the omission results in a half-truth.

55. *Id.*
56. *Id.* at 283–88.
57. This is also how the Second Circuit interpreted this decision. *See infra* note 72.
58. *In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1048–50 (9th Cir. 2014).
59. *Id.* at 1048, 1050.
60. *Id.* at 1054.
61. *Id.*
62. *Id.* at 1055.
63. *Id.*
64. 15 U.S.C. § 77k(a) (2018).
65. *NVIDIA*, 768 F.3d at 1055–56; *see* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1327 n.3 (2015) (distinguishing this dimension of liability under section 11 from a claim based on a failure to state facts necessary to make the statements made not misleading). The court in *NVIDIA* erroneously stated that similar language appears in section 12(a)(2) of the Securities Act, 15 U.S.C. § 77*l*(a)(2) (2018). 768 F.3d at 1055.
66. *NVIDIA*, 768 F.3d at 1056.

4. *Stratte-McClure*

Plaintiffs alleged that Morgan Stanley made material misstatements and omissions in violation of Rule 10b-5 in an effort to conceal its exposure to and losses from the subprime mortgage market, including the failure to disclose that it was likely to incur significant additional losses.[67]

After noting that it has consistently held that an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts,[68] the court stated that Item 303, which imposes disclosure requirements on companies filing SEC-mandated reports, "can serve as the basis for a Section 10(b) securities fraud claim."[69] Forms 10-Q, as with Securities Act registration statements and prospectuses, are mandatory filings that "speak . . . to the entire market."[70] Because these regulations are "obligatory," "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 . . . revenues or income from continuing operations.'"[71] Thus, Item 303 imposes the type of duty to speak that can give rise to liability under Rule 10b-5.[72]

The court further noted, however, that an omission of information required by Item 303 is not by itself sufficient to support a claim under Rule 10b-5 because Rule 10b-5 reaches only "material" omissions.[73] Consistent with *Oran* and *NVIDIA*, the Second Circuit recognized that the disclosure threshold applicable to Item 303 is lower than the materiality test of *Basic*, which applies to Rule 10b-5.[74] Therefore, a violation of the Item 303 disclosure requirements "can only sustain a claim under Section 10(b) and Rule 10b-5 if the allegedly omitted information satisfies *Basic*'s test for materiality."[75]

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67. Stratte-McClure v. Morgan Stanley, Corp., 776 F.3d 94, 97–98 (2d Cir. 2015).

68. *Id.* at 101.

69. *Id.* This is in addition to liability where the failure of disclosure results in a half-truth. *Id.* at 102.

70. *Id.* (quoting Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1222 (1st Cir. 1996)).

71. *Id.* at 102 (quoting Item 303). Professor Grundfest rejects this basis for liability. Grundfest, *supra* note 39, at 29–36. In its brief as amicus curiae in the Supreme Court in *Leidos*, the Government supported this theory. *See* Brief for the United States as Amicus Curiae Supporting Respondents at 7, Leidos Inc. v. Ind. Pub. Ret. Sys., No. 16-581, 2017 WL 4004533, at *7 (Sept. 30, 2017).

72. *Stratte-McClure*, 776 F.3d at 102. The court noted that this conclusion appeared to be "at odds with" *NVIDIA*, which relied on *Oran*:

> Contrary to the Ninth Circuit's implication [in *NVIDIA*] that *Oran compels* a conclusion that Item 303 violations are never actionable under 10b-5, *Oran* actually suggested, without deciding, that in certain instances a violation of Item 303 *could* give rise to a material 10b-5 omission. At a minimum, *Oran* is consistent with our decision that failure to comply with Item 303 in a Form 10-Q can give rise to liability under Rule 10b-5 so long as the omission is material under *Basic*, and the other elements of Rule 10b-5 have been established.

Id. at 103.

73. *Id.*

74. *Id.*

75. *Id.*

5. *SAIC/Leidos*

This case arose from a series of alleged material misstatements and omissions in SAIC's public filings regarding its exposure to liability for employee fraud, an alleged known trend or uncertainty of the type required by Item 303.[76] The lower court did not directly address the extent to which a failure to comply with Item 303 was actionable under Rule 10b-5.[77] The opinion on this issue on appeal focused on whether the plaintiffs had adequately alleged noncompliance with Item 303 and the scienter required under Rule 10b-5.[78] The court of appeals vacated the dismissal of the action insofar as it related to claims based on noncompliance with Item 303.[79] Because the court simply followed *Stratte-McClure* on this point,[80] there was no further substantive discussion of whether noncompliance with Item 303 provides the basis for a Rule 10b-5 claim.

The Supreme Court granted defendants' petition for certiorari, which presented the following question: "Whether the Second Circuit erred in holding . . . that Item 303 of SEC Regulation S-K creates a duty to disclose that is actionable under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5."[81] After the parties settled the case the petition for certiorari was dismissed by agreement.[82]

Thus, there is no definitive answer from the Supreme Court whether the failure to disclose material information expressly required by an SEC regulation, in and of itself, supports a Rule 10b-5 private claim for damages when there is no basis for a half-truth claim. Defendants therefore remain exposed, in at least the Second Circuit, to a Rule 10b-5 claim based on the material breach of a failure to comply with an Exchange Act reporting requirement.[83]

IV. Safe Harbors Applicable to Rule 10b-5

The SEC has adopted rules that provide that noncompliance with certain mandatory disclosure requirements is not a *per se* violation of Rule 10b-5.

76. Ind. Pub. Ret. Sys. v. SAIC, Inc., 818 F.3d 85, 94 (2d Cir. 2016).

77. *See In re* SAIC, Inc. Sec. Litig., No. 12 Civ. 1353(DAB), 2014 WL 4953614 (S.D.N.Y. Sept. 30, 2014) (denying plaintiffs' motion to vacate order of dismissal and denying motion for leave to file amended complaint); *In re* SAIC, Inc. Sec. Litig., No. 12 Civ. 1353(DAB), 2014 WL 407050 (S.D.N.Y. Jan. 30, 2014) (granting defendants' motion to reconsider and then granting motion to dismiss with prejudice); *In re* SAIC, Inc. Sec. Litig., No. 12 Civ. 1353(DAB), 2013 WL 5462289 (S.D.N.Y. Sept. 30, 2013) (granting motion to dismiss the complaint).

78. *Ind. Pub. Ret. Sys.*, 818 F.3d at 94–97.

79. *Id.* at 98.

80. *Id.* at 94 n.7. A recent decision by a district court in the Second Circuit continued to recognize, in dictum, that noncompliance with Item 303 can provide the underpinning for a Rule 10b-5 claim. *See* Axar Master Fund, Ltd. v. Bedford, 308 F. Supp. 3d 743, 758 n.90 (S.D.N.Y. 2018).

81. Petition for Writ of Certiorari at i, Leidos Inc. v. Ind. Pub. Ret. Sys., No. 16-581, 137 S. Ct. 1395 (2017), 2016 WL 6472615, at *I (cert. granted).

82. 138 S. Ct. 2670 (2018).

83. The Second Circuit is the jurisdiction where the most, or second most, securities class actions are filed each year. *See* Cornerstone Research, Securities Class Actions Filings 2017: Year in Review 34 (2017), https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2017-YIR.

A. Rule 10b-18

For the sake of completeness insofar as Rule 10b-5 safe harbors are concerned, note should be taken of a more conventional safe harbor, Rule 10b-18.[84] This longstanding rule provides a roadmap for protection from the prohibitions on manipulation imposed by section 9(a)(2) of the Exchange Act[85] and Rule 10b-5. As explained in the leading securities law treatise, "Rule 10b-18 is a *non*mandatory, *non*exclusive means of effecting issuer repurchases without violating the general antimanipulative provisions of the federal securities laws."[86]

B. Regulation FD

SEC Regulation FD (FD standing for "fair disclosure"),[87] in general terms, requires public disclosure of information when the company or certain corporate officials[88] privately disclose previously nonpublic material information to a person in a covered category.[89] This is intended to preclude favoring some investors with information not available to others.[90] If a selective disclosure is made intentionally, the required public disclosure must be made simultaneously; if the selective disclosure is "non-intentional" the public disclosure must be made "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange)."[91] The public disclosure must be made by the company, either by filing

84. 17 C.F.R. § 240.10b-18 (2018). The rule was first adopted in Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, Securities Act Release No. 6,434, 47 Fed. Reg. 53333 (1982) [hereinafter 10b-18 Adopting Release].

85. 15 U.S.C. § 78i(a)(2) (2018) (providing that it is unlawful, among other acts, "[t]o effect, alone or with 1 or more other persons, a series of transactions in any security registered on a national securities exchange . . . creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others"). The rule provides:

> [Rule 10b-18] provides an issuer (and its affiliated purchasers) with a "safe harbor" from liability for manipulation under sections 9(a)(2) of the Act and [Rule 10b-5] under the Act solely by reason of the manner, timing, price, and volume of their repurchases when they repurchase the issuer's common stock in the market in accordance with the section's manner, timing, price, and volume conditions. As a safe harbor, compliance with [Rule 10b-18] is voluntary.

Preliminary Note 1 to Rule 10b-18, 17 C.F.R. § 240.10b-18 (2018).

86. 9 Louis Loss, Joel Seligman & Troy Parades, Securities Regulation 77 (5th ed. 2018) (footnote omitted).

87. 17 C.F.R. pt. 243 (2018).

88. Regulation FD, Rules 100(a), 101(c), 17 C.F.R. §§ 243.100(a), 243.101(c) (2018).

89. Regulation FD, Rule 100(b)(1), 17 C.F.R. § 243.100(b) (2018). In general terms, these are a broker or dealer, an investment adviser, an investment company, and "a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information." *Id.*

90. Selective Disclosure and Insider Trading, Securities Act Release No. 7,881, 65 Fed. Reg. 51716, 51716 (Aug. 24, 2000) [hereinafter FD Adopting Release]. The underlying purpose of Regulation FD is to prevent the misuse of information. *See id.* (stating as a rationale for adopting Regulation FD that where selective disclosure has occurred "those who were privy to the information beforehand were able to make a profit or avoid a loss at the expense of those kept in the dark").

91. Regulation FD, Rules 100(a), 101(d), 17 C.F.R. §§ 243.100(a), 101(e) (2018).

a Form 8-K[92] or by "disseminat[ing] the information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[93]

When it first proposed Regulation FD the SEC explained that the regulation was designed to create reporting duties only under sections 13(a) and 15(d) of the Exchange Act, and that the SEC did not intend to create duties under section 10(b) or any other provision of the federal securities laws.[94] When Regulation FD was adopted the SEC included language in the final regulation to clarify the impact of the regulation on Rule 10b-5. The SEC explained:

> [T]o remove any doubt that private liability will not result from a Regulation FD violation, we have revised Regulation FD to make absolutely clear that it does not establish a duty for purposes of Rule 10b-5 under the [Exchange Act]. The regulation now includes an express provision in the text stating that a failure to make a disclosure required solely by Regulation FD will not result in a violation of Rule 10b-5.[95]

The SEC elaborated that the Regulation FD safe harbor "should be distinguished from other reporting requirements under Section 13(a) or 15(d) *which do create a duty to disclose for purposes of Rule 10b-5*."[96] Thus, the SEC's position appears to have been that in the absence of a dispensation by the SEC, the failure to comply with an affirmative Exchange Act reporting requirement is a breach of a duty to disclose and is actionable under Rule 10b-5, so long as the other elements of a violation of the rule are established.[97] That was the matter at issue in the cases described in Part III.B of this article. This remains the position of the SEC, as reflected in the brief that the Government filed as amicus curiae in *Leidos* in the Supreme Court.[98]

Rule 102 of Regulation FD now provides, "No failure to make a public disclosure required solely by [Rule 100 of Regulation FD] shall be deemed to be a violation of [Rule 10b-5]."[99] Because of this rule, the SEC stated, "private plaintiffs cannot rely on an issuer's violation of Regulation FD as a basis for a private action alleging Rule 10b-5 violations."[100] The safe harbor would not, however, affect any existing grounds for liability under Rule 10b-5.[101] For example, an is-

92. Form 8-K is discussed in more detail in *infra* Part IV.D.

93. Regulation FD, Rule 101(e), 17 C.F.R. § 243.101(e) (2018).

94. Proposed Rule: Selective Disclosure and Insider Trading, Securities Act Release No. 7,787, 64 Fed. Reg. 72590, 72598 (Dec. 28, 1999).

95. FD Adopting Release, *supra* note 90, 65 Fed. Reg. at 51718.

96. *Id.* at 51726 n.86 (emphasis added).

97. *See also* Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 7,607, 63 Fed. Reg. 67331, 67336 (Dec. 4, 1998) (reflecting that duty to disclose can be "triggered" under Rule 10b-5 "line-item disclosure requirements in filings with the Commission").

98. In *Leidos*, the United States' amicus curiae brief, which was also signed by the SEC, endorsed "[t]he SEC's longstanding and consistent position . . . that a violation of Item 303 or other SEC disclosure obligation can be the predicate for a Rule 10b-5 claim." Brief for the United States as Amicus Curiae Supporting Respondents at 22, Leidos Inc. v. Ind. Pub. Ret. Sys., No. 16-581, 2017 WL 4004533, at *22 (Sept. 30, 2017).

99. 17 C.F.R. § 243.102 (2018).

100. FD Adopting Release, *supra* note 90, 65 Fed. Reg. at 51726.

101. *Id.*

suer's failure to make a public disclosure may still give rise to liability under a "duty to correct" or "duty to update" theory in certain circumstances.[102] If an issuer's filing or public disclosure made under Regulation FD was materially misleading the issuer could also still incur Rule 10b-5 liability.[103]

Under Regulation FD a disclosure is made intentionally when "the person making the disclosure either knows, or is reckless in not knowing, that the information . . . is both material and nonpublic."[104] The SEC explained:

> [W]e have made clear that where the regulation speaks of "knowing or reckless" conduct, liability will arise only when an issuer's personnel knows or is reckless in not knowing that the information selectively disclosed is both material and nonpublic. This will provide additional assurance that issuers will not be second-guessed on close materiality judgments. Neither will we, nor could we, bring enforcement actions under Regulation FD for mistaken materiality determinations that were not reckless.[105]

The SEC thus recognized the difficult materiality judgments that may arise under stringent time constraints when deciding whether Regulation FD requires a public disclosure, whether or not the selective disclosure was intentional.[106]

C. Regulation G

Regulation G[107] was adopted by the SEC in compliance with a mandate imposed by section 401(b) of the Sarbanes-Oxley Act of 2002.[108]

> As directed by the Sarbanes-Oxley Act of 2002, we are adopting new rules and amendments to address public companies' disclosure or release of certain financial information that is calculated and presented on the basis of methodologies other than in accordance with generally accepted accounting principles (GAAP). We are adopting a new disclosure regulation, Regulation G, which will require public companies that disclose or release such non-GAAP financial measures to include, in that disclosure or release, a presentation of the most directly comparable GAAP financial

102. *Id.* An issuer has a duty to correct a statement that it later discovers was misleading when made. Some courts have recognized a duty to update a statement with a forward-looking or ongoing component that was accurate when made if the statement later becomes inaccurate when it is still "alive" in the marketplace, that is, when the out-of-date statement is still being relied upon by investors. *See* Nagy et al., *supra* note 16, at 54–57; Cox et al., *supra* note 37, at 723–24.

103. FD Adopting Release, *supra* note 90, 65 Fed. Reg. at 51726.

104. Regulation FD, Rule 101(a), 17 C.F.R. § 243.101(a) (2018).

105. FD Adopting Release, *supra* note 90, 65 Fed. Reg. at 51718.

106. The SEC's pledge not to bring enforcement actions under Regulation FD for close calls on materiality may have been broken when it sued Siebel Systems, Inc. In dismissing the complaint in that case, the court observed, "[T]he SEC has scrutinized, at an extremely heightened level, every particular word used in the statement, including the tense of verbs and the general syntax of each sentence. . . . Such an approach places an unreasonable burden on a company's management and spokespersons . . . ." SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 704 (S.D.N.Y. 2005).

107. 17 C.F.R. pt. 244 (2018).

108. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, 786–87 (2002) (codified as amended at 15 U.S.C. § 7261(b) (2018)).

measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.[109]

The SEC took an approach vis-à-vis Rule 10b-5 with respect to disclosures required by Regulation G comparable to what it had done less than a year earlier in Regulation FD:

> Rule 102 of Regulation G expressly provides that neither the requirements of Regulation G nor a person's compliance or non-compliance with the requirements of Regulation G shall in itself affect any person's liability under Exchange Act Section 10(b) or Rule 10b-5 thereunder. Disclosure pursuant to Regulation G that is materially deficient may, in addition to violating Regulation G, give rise to a violation of Section 10(b) or Rule 10b-5 thereunder if all the elements for such a violation are present.[110]

That was all that the SEC stated in explaining the adoption of this safe harbor in both the release proposing Regulation G[111] and the one adopting it. Rule 102 of Regulation G today provides, "Neither the requirements of [Regulation G] nor a person's compliance or non-compliance with the requirements of this Regulation shall in itself affect any person's liability under [section 10(b) or Rule 10b-5]."[112] This exclusion is not identical to the one adopted in Regulation FD. The SEC did not explain if there was any significance to the difference in wording.

D. Rules 13a-11 and 15d-11

SEC Form 8-K provides for current disclosure of specific events deemed by the SEC to be significant to investors that occur between the quarterly cycle for filing Forms 10-Q (for each of a reporting company's first three fiscal quarters) and the annual Form 10-K.[113] In 2002 the SEC proposed expanding the list of events mandating a current report and to accelerate the filing date.[114]

In the 2002 8-K Proposing Release the SEC also proposed to include a safe harbor from liability under Exchange Act sections 13 and 15(d)[115] for all items of Form 8-K.[116] Recognizing the burden to satisfy the enhanced reporting

109. Final Rule: Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8,176, 68 Fed Reg. 4820, 4820 (Jan. 30, 2003) [hereinafter Regulation G Adopting Release].

110. *Id.* at 4823 (footnotes omitted).

111. Proposed Rule: Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8,145, 67 Fed. Reg. 68790 (Nov. 13, 2002). For criticism of this safe harbor, see *infra* text accompanying notes 155–57.

112. Regulation G, Rule 102, 17 C.F.R. § 244.102 (2018).

113. For the current requirement to file a Form 8-K, see, for example, SEC Rule 13a-11(a), 17 C.F.R. § 240.13a-11(a) (2018); *Form 8-K*, U.S. Sec. & Exchange Commission, https://www.sec.gov/files/form8-k.pdf (last visited Sept. 24, 2018). Rule 13a-11 applies to companies reporting because they have a class of securities registered under section 12 of the Exchange Act. Rule 15d-11 applies to companies reporting because they are required to do so by section 15(d). *See supra* note 10. The discussion here focuses on Rule 13a-11.

114. Proposed Rule, Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8,106, 67 Fed. Reg. 42914 (June 25, 2002) [hereinafter 2002 8-K Proposing Release].

115. 15 U.S.C. §§ 78m, 78o(d) (2018).

116. 2002 8-K Proposing Release, *supra* note 114, 67 Fed. Reg. at 42919.

obligations that the expansion of Form 8-K would impose, the SEC proposed to "subject[] Form 8-K disclosure to the appropriate level of liability" while "ensur [ing] that our rules promote the dissemination of high-quality, balanced disclosure" without sacrificing "quality" for the "sake of speed."[117] The SEC further explained the proposed safe harbor as follows:

> To accommodate companies that do not file a report in a timely manner despite making a good faith effort to file such reports, we are proposing to create a safe harbor. The proposal would add a new paragraph to each of Rule 13a-11 and Rule 15d-11 under the Exchange Act. The proposed new paragraphs would provide a safe harbor for a company that fails to file a required Form 8-K in a timely manner if the company satisfies all of the safe harbor's conditions. Under the proposed safe harbor, a company would not be liable under Sections 13 and 15(d) of the Exchange Act for such a failure to file if [the conditions are satisfied].
>
> A company that complies with these requirements would not be liable for a violation of Section 13(a) or 15(d). This safe harbor, however, would not provide protection for violations of other provisions of the securities laws. Accordingly, the obligation to disclose information on Form 8-K would not be affected by the safe harbor and thus would continue to exist for purposes of determining liability under Section 10 and Rule 10b-5 under the Exchange Act and Sections 11, 12 and 17 of the Securities Act.[118]

The law firm Shearman & Sterling commented that the proposed safe harbor was too narrow and recommended that the SEC extend it to Rule 10b-5.[119] The firm argued in part as follows in support of a safe harbor from Rule 10b-5:

> Given the increased number of Form 8-K filings that will be required by the proposed rule, the difficulty in determining whether a reporting obligation has been triggered and the short time frame for filing the report, there is a good chance that a registrant will inadvertently miss a Form 8-K filing. Without a broader safe-harbor, registrants will be exposed to civil liability under Rule 10b-5 in private actions if they fail to timely file a Form 8-K. Without an effective safe-harbor for Rule 10b-5 actions, even those companies acting in good faith will be subject to inordinate risks of antifraud liability to those trading in the market simply based on good faith judgments that Form 8-K disclosures were not required or, even worse, as a result of inadvertence. Liabilities based on the value of trading could be huge and potentially crippling to a company.[120]

The firm did not offer any further legal analysis, such as the specific basis for "civil liability under Rule 10b-5" for which the proposed safe harbor would provide protection. In particular, it said nothing about the concept of liability under Rule 10b-5 for the complete failure to file material information required by the Exchange Act reporting requirements, the issue addressed by the cases discussed

117. *Id.* at 42929.
118. *Id.* (footnotes omitted).
119. Letter from Shearman & Sterling LLP to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 30, 2002), https://www.sec.gov/rules/proposed/s72202/shearman1.htm.
120. *Id.*

in Part III.B of this article, only one of which preceded the proposed amendments to Form 8-K.

Several other commenters proposed a Rule 10b-5 safe harbor. One wrote, "We believe the proposed safe harbor should be expanded to include protection from other liability provisions, including Section 10 of the Exchange Act and Section 11 of the Securities Act."[121] A third stated that it "agrees with the Commission's suggestion to extend the safe harbor to Rule 10b-5 and Section 11."[122] It is not apparent what SEC "suggestion" was referred to.

In response to these comments,[123] in the final rule the SEC changed its approach to protecting companies that failed to make a required disclosure. In the final rule changes pertaining to Form 8-K, when the SEC added more items triggering disclosure and required that most mandated disclosures be made within four business days of the triggering event,[124] the SEC adopted a safe harbor from liability under Rule 10b-5, albeit only for some items in Form 8-K. The SEC explained:

> While we are not convinced that we should extend a Section 10(b) and Rule 10b-5 safe harbor to all of the Form 8-K items, we recognize that several of the new Form 8-K disclosure items may require management to quickly assess the materiality of an event or to determine whether a disclosure obligation has been triggered. In this respect, these items raise issues analogous to those we considered in our adoption of the Section 10(b) and Rule 10b-5 safe harbor under Regulation FD.
>
> As a result, we have decided to adopt a new limited safe harbor from public and private claims under Exchange Act Section 10(b) and Rule 10b-5 for a failure to timely file a Form 8-K regarding [certain items].
>
> In light of this new limited safe harbor under Section 10(b) and Rule 10b-5, we have eliminated the proposed safe harbor from liability under Section 13(a) or 15(d). As a result, the new safe harbor will not affect our ability to enforce any of the Form 8-K filing requirements under these sections.
>
> The safe harbor for these items states that no failure to file a report on Form 8-K that is required solely pursuant to the provisions of Form 8-K shall be deemed to be a violation of Section 10(b) and Rule 10b-5 under the Exchange Act. The safe harbor only applies to a failure to file a report on Form 8-K. Thus, material misstatements or omissions in a Form 8-K will continue to be subject to Section 10(b) and Rule 10b-5 liability.
>
> In addition, if the company has a duty to disclose information that is the subject of any of the Form 8-K items covered by the safe harbor for any reason apart from

121. Letter from Comm. on Sec. Reg. of the Ass'n of the Bar of the City of N.Y. to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 26, 2002), https://www.sec.gov/rules/proposed/s72202/rflangan1.htm.

122. Letter from the Nat'l Ass'n of Real Estate Inv. Trusts to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n (Aug. 26, 2002), https://www.sec.gov/rules/proposed/s72202/tmedwards1.htm.

123. The SEC cited four comment letters as having suggested a Rule 10b-5 safe harbor, including the Shearman & Sterling letter. Additional Form 8–K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8,400, 58 Fed. Reg. 15594, 15606 n.130 (Mar. 25, 2004) [hereinafter 2004 8-K Adopting Release]. In addition to the three quoted in the text, the SEC cited a letter from Emerson Electric Co. That letter is not in the electronic file of comment letters on the proposal.

124. *Id.* at 15619–27.

> the Form 8-K requirement, the safe harbor will not provide protection from Section 10(b) and Rule 10b-5 that may arise from the company's failure to satisfy such separate disclosure obligation.[125]

The SEC thus adopted Rule 13a-11(c), which currently provides, "No failure to file a report on Form 8-K that is required solely pursuant to Item 1.01, 1.02, 2.03, 2.04, 2.05, 2.06, 4.02(a), 5.02(e) or 6.03 of Form 8-K shall be deemed to be a violation of [section 10(b) and Rule 10b-5]."[126] Although there was no further explanation of the rationale for this safe harbor, presumably the SEC continued to rely on its position that, absent a safe harbor, the failure to comply with a mandatory disclosure requirement would be a breach of duty actionable under Rule 10b-5.[127]

In 2005, the SEC added disclosures regarding asset-backed securities to Form 8-K.[128] The SEC extended the Rule 10b-5 safe harbor to only one of those new items, Item 6.03.[129] The SEC explained that among the new ones only this item, which relates to a change in credit enhancement or other external support, "appears to meet the criteria of the existing subset of Form 8-K items to which the safe harbor applies," criteria that are "premised on the recognition that [items protected by the safe harbor] may require quick assessments of the materiality of the event, adding difficulty to the determination of whether a triggering event has occurred."[130]

In 2006 the SEC added Item 5.02(e) to Form 8-K, requiring disclosures in connection with the adoption or amendment of a material compensatory plan between the company and certain senior officers.[131] The SEC amended the safe harbors applicable to Form 8-K to include Item 5.02(e) for the reasons relied on in 2004.[132]

Thus, beginning in 2000, with Regulation FD, the SEC has adopted targeted provisions excluding *per se* liability under Rule 10b-5 for a complete failure to comply with an Exchange Act mandatory disclosure requirement. These safe

125. *Id.* at 15606–07 (footnotes omitted).

126. 17 C.F.R. § 240.13a-11(c) (2018). As adopted in 2004, the safe harbor applied to Items 1.01 (Entry into a Material Definitive Agreement), 1.02 (Termination of a Material Definitive Agreement), 2.03 (Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant), 2.04 (Triggering Events that Accelerate or Increase a Direct Financial Obligation Under an Off-Balance Sheet Arrangement), 2.05 (Costs Associated with Exit or Disposal Activities), 2.06 (Material Impairments), and 4.02(a) (Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review) (in the case where a company makes the determination and does not receive a notice described in Item 4.02(b) from its accountant). The inclusion of Items 5.02(e) and 6.03 is discussed at *infra* text accompanying notes 128–32.

127. *See supra* text accompanying notes 96–98 (stating the SEC's position).

128. Asset Backed Securities, Securities Act Release No. 8,518, 70 Fed. Reg. 1506, 1625 (Jan. 7, 2005) (adding Items 6.01–6.05 to Form 8-K).

129. *Id.* at 1579.

130. *Id.*

131. Executive Compensation and Related Person Disclosure, Securities Act Release No. 8,732A, 71 Fed. Reg. 53158, 53265 (Sept. 8, 2006).

132. *Id.* at 53196 ("the risk of liability under these provisions for the failure to timely file was disproportionate to the benefit of real-time disclosure and therefore justified the need for a limited safe harbor of a fixed duration").

harbors exclude liability where compliance with the disclosure requirement in question presented a particularly difficult disclosure decision, especially under significant time constraints. These safe harbors apply to both private claims for damages and an SEC enforcement action based on Rule 10b-5. *Materially defective* compliance when making disclosure remains subject to Rule 10b-5, and the SEC retains the power to bring an enforcement action for a failure to make the required disclosure, albeit not under Rule 10b-5.[133]

V. Proposed Additional Rule 10b-5 Safe Harbors

There are several additional significant SEC disclosure requirements that merit consideration for the adoption of a Rule 10b-5 safe harbor that would insulate a complete failure to make a required disclosure from an action based on Rule 10b-5, comparable to the safe harbors discussed in Part IV. Because of the difficult judgments, often under severe time constraints, that are involved in deciding *whether* any disclosure is required under a particular rule, a dispensation from liability for the failure to make disclosure is in order, comparable to Regulation FD and Rule 13a-11, discussed above in Parts IV.B and D, or for other reasons explained below.

A. The Utility of a Rule 10b-5 Safe Harbor

When a company has entirely failed to make a required disclosure, a claim might proceed under Rule 10b-5 based on the breach of a duty to disclose, as discussed in Parts III.B.4 and 5. Unless and until the Supreme Court resolves the question that had been presented in the *Leidos* petition for certiorari,[134] defendants will remain potentially liable in an action under Rule 10b-5 in at least some circuits, particularly the Second Circuit, solely for the failure to make a required material disclosure.[135] If the Supreme Court were to resolve the apparent split among the circuits in favor of the defendants, the need for the safe harbors proposed here, as well as for the ones already adopted by the SEC, is likely to be substantially diminished. If the split were resolved in favor of the plaintiffs, how-

133. To seek a remedy for a violation of an Exchange Act disclosure requirement the SEC could proceed, for example, (1) under section 15(c)(4), 15 U.S.C. § 78o(c)(4) (2018), which empowers the SEC to require a person who violated a reporting requirement to comply with the provision that was violated; (2) under section 21(d), 15 U.S.C. § 78u(d) (2018), which empowers a court to grant injunctive relief and impose civil monetary penalties for violation of a rule; and (3) under section 21C, 15 U.S.C. § 78u-3 (2018), which empowers the SEC administratively to grant a cease-and-desist order and to order compliance with the law, as well as to impose a civil monetary penalty under section 21B(a)(2), 15 U.S.C. § 78u-2(a)(2) (2018). *See* Grundfest, *supra* note 39, at 5, 20–21 (discussing enforcement remedies for noncompliance with Exchange Act reporting requirements). As Professor Grundfest notes, the SEC need not prove scienter to establish entitlement to a remedy under these provisions. *Id.* However, the amount of a civil monetary penalty can be enhanced "if the violation . . . involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." *See, e.g.*, Exchange Act § 21(d)(3)(B)(ii), 15 U.S.C. § 78u(d)(3)(B)(ii) (2018).

134. *See supra* text accompanying note 81.

135. *See supra* text accompanying note 83.

ever, the utility of these safe harbors would be increased. This article is written in the context of uncertainty about what the law is on this point.

It can be argued that concern based on potential liability arising out of the breach of a duty to disclose is illusory because this theory of liability is superfluous. This argument is grounded in the contention that the failure to make a disclosure in a document that is public, such as a Form 10-K, may often, perhaps invariably, be cast as the omission to state a material fact necessary in order to make the statements that are made in the filing not misleading, the so-called half-truth, which is undeniably prohibited by Rule 10b-5(b).[136] Therefore, the argument goes, the sturm and drang over the Item 303 duty to disclose is much ado about nothing. Professor Grundfest made this argument, observing, "With so much affirmative information from the company entering the public domain it becomes trivially easy for plaintiffs to allege that material omissions cause affirmative statements to become materially misleading."[137] If this is so, then shielding a defendant from pure omission claims is a meaningless gesture.

There are at least two answers to this objection. First, the SEC appears to have adopted Rule 10b-5 safe harbors because it is of the view that a total failure to file a required report *is* actionable under Rule 10b-5 independent of the half-truth approach.[138] While it is true that noncompliance with the known trends component of Item 303, for example, will most likely have a half-truth element, this is not true where no document at all is filed, as in the case of a failure to file a Form 8-K that was required by only one of the Form 8-K items or the failure to file a Form 8-K or make other public disclosure when required by Regulation FD. In that event there is no document likely to be rendered misleading by a non-filing. This is also true for some of the proposals made below.[139]

Second, by excluding by rule and therefore eliminating altogether the argument based on breach of a duty to disclose, any litigation will focus on whether there was a half-truth, significantly simplifying the legal issues.

Another argument in opposition to adopting safe harbors such as those proposed here is that if the failure to file was based on a good-faith judgment that the information in question was not material, there would be no liability under Rule 10b-5 in any event, because the rule reaches only conduct with an element of scienter.[140] A defendant may not have acted with scienter if it made a thoughtful, good-faith judgment that the information was not material.[141] In other words, a decision made without scienter does not present Rule 10b-5 exposure.

136. *See, e.g.*, *supra* text accompanying note 37.

137. Grundfest, *supra* note 39, at 5.

138. *See supra* text accompanying notes 96–98 (stating the SEC's position).

139. *See infra* Part V.E (regarding Rule 506(b)), Part V.F (regarding Rule 701), and Part V.G (regarding section 13(d)).

140. *See supra* text accompanying notes 21–23.

141. *See* Allan Horwich, *An Inquiry into the Perception of Materiality as an Element of Scienter Under SEC Rule 10b-5*, 67 Bus. Law. 1, 30, 35–36 (2011) (concluding that a defendant who gave careful analysis, including seeking advice of counsel, in determining that the facts he decides not to disclose were not material has not acted recklessly in violation of Rule 10b-5 even if the facts were material).

The response to this argument is that a determination of no liability because there was no scienter *in fact* can be made only on the merits, after potentially sweeping discovery in a case, on summary judgment at the earliest. If the plaintiff is able to make allegations in the complaint that support a strong inference of scienter, the case will proceed with discovery, as long as the other elements of the Rule 10b-5 claim are satisfied by the complaint.[142] It is little comfort to the defendant that it prevailed in the end, after years of discovery and substantial legal fees.

A similar problem has arisen in the application of safe harbor rules that the SEC adopted which deemed a forward-looking statement not fraudulent "unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."[143] As explained in a leading casebook, "Because the existence of bad faith and a reasonable basis are generally questions of fact for which a hearing is necessary, those rules do not ordinarily enable defendants to obtain a dismissal at an early state of the proceedings."[144] By adopting a safe harbor that precludes at the outset a claim based entirely on the failure to file, the risk that a case will proceed to discovery is eliminated.[145]

While these proposed safe harbors would also preclude SEC Rule 10b-5 enforcement claims based solely on a failure to file, nothing in either the existing safe harbors or those proposed here would impair the SEC's ability to proceed against anyone for failure to comply with a disclosure requirement.[146]

B. The Rationale for the Safe Harbors

The purpose of the safe harbors proposed here is to exclude from the scope of Rule 10b-5 those situations where a company or other person otherwise reachable under the rule is confronted with a time-sensitive and intricate disclosure question, such as whether facts are material. As the SEC apparently recognized in adopting the Rule 13a-11 safe harbor, many of the SEC's rules require a company to make difficult disclosure decisions under considerable time pressure, such as the four-day requirement for Form 8-K and the simultaneous or prompt requirement under Regulation FD.[147]

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142. *See* Exchange Act § 21D(b)(2)(A), 15 U.S.C. § 78u-4(b)(2)(A) (2018) (providing that in a private action for damages under Rule 10b-5, where scienter is an element of the claim, "the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322–24 (2007) (interpreting section 21D(b)(2)(A)).

143. *See, e.g.*, Exchange Act Rule 3b-6, 17 C.F.R. § 240.3b-6 (2018).

144. Nagy et al., *supra* note 16, at 72.

145. This was the purpose of the statutory safe harbor for forward-looking statements adopted in the PSLRA. *See, e.g.*, Exchange Act § 21E, 15 U.S.C. § 78u-5 (2018); Allan Horwich, *Cleaning the Murky Safe Harbor for Forward-Looking Statements: An Inquiry into Whether Actual Knowledge of Falsity Precludes the Meaningful Cautionary Statement Defense*, 35 J. Corp. L. 519, 539–45 (2010) (discussing cases applying the safe harbor in granting motions to dismiss).

146. *See supra* note 133 (identifying enforcement remedies).

147. *See supra* text accompanying notes 91 & 125.

Deciding whether something is material, thus triggering a disclosure obligation, is one of the most difficult decisions an issuer and its lawyer must make. One leading casebook states, "Unfortunately, determining whether a particular morsel of information is material is often an uncertain process."[148] A securities law text cautions, "For the securities lawyer worrying about disclosure, digging to find nonspecified information and then determining whether it is material takes the most skill and judgment."[149] One commentator has observed that "the case-law [of materiality under the federal securities laws] is quixotic at best, and fickle at worst."[150] Another concluded, "Materiality is a notoriously slippery concept, 'unpredictable and elusive' in application."[151] The SEC staff's own guidance on materiality is sometimes frustrating. For example, "When . . . management or the independent auditor expects . . . that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material."[152] The staff continued, however, "If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB."[153] In other words, there is a very useful approach to assessing materiality—but it is not definitive. With respect to the MD&A in particular, more than twenty years ago one writer concluded that

> compliance with the federal securities disclosure laws is an arduous task for public companies even under the best of circumstances. Under Item 303 and its applicable interpretive releases, the MD&A disclosure requirements are open-ended and exceedingly complex. An encounter with the disclosure requirements of the federal securities laws has been aptly described as analogous to "a fencing match conducted on a tightrope."[154]

Cases and commentary attesting to the difficulty in grappling with the concept of material in the real world abound.

While the rationale for these proposed rules seeks to parallel the SEC's explanation for the existing Rule 10b-5 safe harbors, these grounds do not support the Regulation G safe harbor.[155] In adopting Rule 102 of Regulation G the SEC did not offer an independent justification for the protection afforded public reporting companies.[156] No company is required to make financial disclosures that do

148. Stephen J. Choi & A.C. Pritchard, Securities Regulation: Cases and Analysis 48 (4th ed. 2015).

149. Larry D. Soderquist & Theresa A. Gabaldon, Securities Law 75 (5th ed. 2014).

150. Dale A. Oesterle, *The Overused and Under-Defined Notion of "Material" in Securities Law*, 14 U. Pa. J. Bus. L. 167, 167 (2011).

151. Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 Bus. Law. 317, 319 (2007) (quoting SEC v. Bausch & Lomb Inc., 565 F.2d 8, 10 (2d Cir. 1977)).

152. SEC Staff Accounting Bulletin: No. 99—Materiality, 64 Fed. Reg. 45150, 45152 (Aug. 19, 1999) (to be codified at 17 C.F.R. § 211 subpt. B).

153. *Id.* at 45152 n.17.

154. Mark S. Croft, *MD&A: The Tightrope of Disclosure*, 45 S.C. L. Rev. 477, 478 (1994) (quoting SEC v. Bausch & Lomb Inc., 565 F.2d 8, 9 (2d Cir. 1977)).

155. *See supra* Part IV.C.

156. *See supra* text accompanying note 111.

not comply with GAAP, thus triggering further disclosure to comply with Regulation G. Similarly, the *timing* of a non-GAAP disclosure is within the control of the company. While a company may make a non-GAAP disclosure when it files a Form 8-K, Form 10-K, or Form 10-Q that *is* time-driven, it has no obligation to make any related non-GAAP disclosure at the same time. That additional disclosure can be provided later without running afoul of any SEC rule. The only issue that might justify dispensation is that the obligation to provide a reconciliation with GAAP arises only when *material* information included a non-GAAP disclosure,[157] an assessment that is much less problematic than those implicated by the other disclosure requirements addressed here. Even if the Regulation G safe harbor is an outlier in terms of the rationale for it, however, that does not undermine the basis for the other safe harbors the SEC has adopted.

Finally, it is fair to question giving a break to those who violate the law as it has been understood by some courts, by pruning the reach of Rule 10b-5. The first answer is that very little slack is being cut, because the SEC would retain the ability to use all of its other enforcement tools, including obtaining an enhanced penalty when the failure to file was fraudulent.[158] The second answer is that the safe harbor provides only a limited exclusion while causing litigants to focus on established bases of liability, sparing the judicial system the need to wrestle with complex questions of duty.

C. Regulation S-K Item 303 Regarding Known Trends

The guidance the SEC provided for complying with Regulation S-K Item 303(a)(3)(ii), which requires describing "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," reflects the difficult judgments that are involved.[159] The SEC has acknowledged that Item 303 compliance can "be particularly challenging."[160] This parallels the earlier point that materiality judgments themselves are among the most difficult ones faced by the securities lawyer and the client.[161]

If a company were sued under Rule 10b-5 for a failure to comply with the "known trends" disclosure required by the MD&A, the essence of the claim may be that the company made an incorrect judgment that there is no trend or, if there is one, that it is not reasonably expected to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations requiring disclosure in a Form 10-Q or Form 10-K.[162] Because these judgments are often inherently difficult, it seems reasonable to shield the com-

157. Regulation G, Rule 100(a), 17 C.F.R. § 244.100(a) (2018).

158. *See, e.g.*, *supra* note 133.

159. *See supra* text accompanying notes 49–50.

160. Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290, 6295 (Feb. 8, 2010).

161. *See supra* text accompanying notes 148–54.

162. It bears repeating that the factual determination that there is no liability under Rule 10b-5 for a mistake in judgment can be made only after discovery. *See supra* text accompanying notes 142–45.

pany from a Rule 10b-5 claim of this type. The company would not, however, be protected from any other claim, particularly an enforcement claim, for noncompliance with Item 303.

The safe harbor would provide, "No failure to make a public disclosure required solely by Item 303(a)(3)(ii) of Regulation S-K shall be deemed to be a violation of Rule 10b-5. No failure to make a public disclosure required solely by Item 303(b) of Regulation S-K to disclose a material change to information disclosed in response to Item 303(a)(3)(ii) of Regulation S-K shall be deemed to be a violation of Rule 10b-5."

D. Regulation S-K Item 103

Regulation S-K Item 103 requires the reporting company to

> [d]escribe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. . . . Include similar information as to any such proceedings known to be contemplated by governmental authorities.[163]

As with the judgments described regarding Item 303, the decision whether pending litigation is *material* can be a difficult one.[164] Evaluating whether an adverse outcome could have a future impact that proves to be material can entail crystal ball gazing of a high order. "[D]isclosures about legal proceedings [are] challenging because they often include forward-looking information."[165] As stated in the leading securities law treatise, "[D]isclosures of pending legal proceedings often involves complex choices because of the parallel accounting requirements to disclose contingent liabilities and the problem under Item 103 of defining *materiality*."[166] It might be suggested that any close questions should be resolved by applying the principle "when in doubt, disclose." Yet disclosing a

163. 17 C.F.R. § 229.103 (2018). Item 1 of Part II of Form 10-Q (https://www.sec.gov/files/form10-q.pdf) and Item 3 of Part I of Form 10-K (https://www.sec.gov/files/form10-k.pdf) require compliance with Item 103. Item 103 is accompanied by instructions that give more specific guidance, some of which identify matters that may be excluded.

164. In many situations there will have been public disclosure of material litigation by the plaintiff who has sued the company, by a governmental agency that has brought suit, or by the news media. In that event it is possible that the company's failure to disclose the litigation in a Form 10-Q or 10-K will not violate Rule 10b-5. In assessing the materiality of allegedly omitted material, the court may consider information already in the public domain, such as news articles, and facts known or reasonably available to the shareholders. *See* Garber v. Legg Mason, Inc., 347 F. App'x 665, 668 (2d Cir. 2009). If what is in the public domain renders the company's omission immaterial, there can be no claim under Rule 10b-5. The principal quandary for the company thus arises with respect to matters that are otherwise undisclosed, albeit prudence dictates that a company include complete Item 103 disclosure in the appropriate Exchange Act report and not rely on what has been disclosed elsewhere.

165. Broc Romanek, Legal Proceedings Disclosure Handbook: Practice Guide & Toolkit—Item 103 of Regulation S-K 13-7 (2018) (on file with author).

166. 2 Loss et al., *supra* note 86, at 194.

pending matter may be seen as conceding the materiality of the litigation when the defendant has not so concluded.[167]

For these reasons, and taking into account the factors addressed in the preceding discussion of the MD&A, serious consideration should be given to adopting a rule precluding a claim under Rule 10b-5 for the failure to disclose a material litigation matter. The argument for a safe harbor for Item 103, however, is not as strong as the argument with respect to Item 303. Item 103 is more focused than the "known trends" disclosure requirement. Moreover, because Item 3 of Part I of Form 10-K expressly requires a disclosure in compliance with Item 103 on Form 10-K, a statement that there are no such items when in fact there were material proceedings that should have been disclosed may always be vulnerable to the misrepresentation argument under Rule 10b-5(b). This exposure cannot be sidestepped by skipping the item altogether, because the instructions require an entry for each item on the form, even if the item is "inapplicable."[168] For this reason, the safe harbor proposed here may have little practical utility in eliminating Rule 10b-5 exposure for the failure to disclose a material litigation matter.

The safe harbor would provide, "No failure to make a public disclosure required solely by Item 103 of Regulation S-K shall be deemed to be a violation of Rule 10b-5."

E. Regulation D, Rule 506(b)

Rule 506(b) is the safe harbor for a private exempt sale of securities pursuant to section 4(a)(2) of the Securities Act.[169] The rule permits sales to an unlimited number of accredited investors and no more than thirty-five non-accredited but sophisticated investors.[170] The rule mandates that non-accredited sophisticated investors be provided specified company-specific disclosures[171] and a descrip-

167. The company could make the disclosure and then disclaim that the information is immaterial, a judgment the market may not share, however, once the matter has been disclosed.

168. Rule 12b-13 provides in relevant part, "The statement or report shall contain the numbers and captions of all items of the appropriate form . . . . Unless expressly provided otherwise, if any item is inapplicable or the answer thereto is in the negative, an appropriate statement to that effect shall be made." 17 C.F.R. § 240.12b-131 (2018).

169. *See supra* text accompanying notes 14–15 (explaining the safe harbor).

170. Rule 506(b)(2)(i) limits the number of purchasers to thirty-five. 17 C.F.R. § 230.506(b)(2)(i) (2018). Rule 501(e)(1)(iv), however, provides that accredited investors are not included in the count. *Id.* § 230.501(e)(1)(iv) (2018). The non-accredited investors in a Rule 506(b) offering must be sophisticated. *Id.* 17 C.F.R. § 230.506(b)(2)(ii). Accredited investors are defined in Rule 501(a). *Id.* § 230.501(a).

171. Rule 502(b)(1),17 C.F.R. § 230.501(b)(1) (2018). This condition must be satisfied to claim any exemption under Rule 506(b). *See id.* If the issuer is not filing reports under the Exchange Act, the nature of the information to be disclosed is set forth in Rule 502(b)(2)(i).

If the issuer is a public reporting company, the information required to be provided are specified items that have been filed under the Exchange Act or documents that are otherwise public, as specified in Rule 506(b)(2)(ii). While the failure to provide the required material in that context may result in noncompliance with the exemption, that failure is not likely to provide the basis for a deception claim under Rule 10b-5. *See supra* note 164 (explaining that if information not disclosed pursuant to a particular disclosure requirement is otherwise public, the failure of disclosure is not likely a material one in violation of Rule 10b-5).

tion of information that has been provided to accredited investors.[172] The rule does not require that any company-specific disclosure be made to accredited investors, though it is customary to do so.[173]

If the issuer fails to make the required disclosure to sophisticated purchasers, the issuer is not entitled to the exemption from registration and it could be sued under section 12(a)(1) of the Securities Act to rescind the transactions,[174] at least by the non-accredited purchasers who did not receive the required disclosures.[175] The statute of limitations for a claim under section 12(a)(1) in section 13 of the Securities Act provides that suit be filed "within one year after the violation upon which it is based" and in "no event . . . more than three years after the security was bona fide offered to the public."[176] This presents the question whether the sophisticated purchaser who is not accredited, who did not receive the disclosure required in a Rule 506(b) transaction, and who did not timely sue under section 12(a)(1), or even if he did, could (also) sue under Rule 10b-5, claiming that the issuer failed to satisfy the mandatory disclosure requirement, thus deceiving the investor because a required material disclosure was not made.[177]

172. A condition of a Rule 506(b) transaction is:

> At a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction under § 230.506(b), the issuer shall furnish to the purchaser a brief description in writing of any material written information concerning the offering that has been provided by the issuer to any accredited investor but not previously delivered to such unaccredited purchaser. The issuer shall furnish any portion or all of this information to the purchaser, upon his written request a reasonable time prior to his purchase.

Rule 502(b)(2)(iv), 17 C.F.R. § 230.502(b)(2)(iv) (2018).

173. The SEC has suggested, "When an issuer provides information to investors pursuant to paragraph [502](b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws." Note to Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1).

174. 15 U.S.C. § 77*l*(a)(1) (2018) (granting a cause of action by the buyer against a seller who "offers or sells a security in violation of section 5" (15 U.S.C. § 77e (2018)), which requires registration of a non-exempt securities offering). The elements of the section 12(a)(1) claim are that there was a violation of section 5 (a sale of securities without registration) using the facilities of interstate commerce, the buyer-plaintiff has tendered his securities to the seller-defendant, and the claim was filed within the limitations period. COX ET AL., *supra* note 37, at 528. The defendant bears the burden of showing that the transaction was exempt from registration. *See* 9 LOSS ET AL., *supra* note 86, at 251.

175. Rule 508(a), 17 C.F.R. § 230.508(a) (2018) (limiting the section 12(a)(1) cause of action where there has been noncompliance with a Regulation D exemption). Notably a section 12(a)(1) claim is not available where, among other conditions, "[t]he failure to comply did not pertain to a term, condition or requirement directly intended to protect [the complaining] individual or entity." *Id.* The failure to provide disclosures to a non-accredited investor may thus not provide the basis for a claim by an accredited investor, as the disclosure mandate was not included to protect an accredited investor.

176. 15 U.S.C. § 77m (2018).

177. The statute of limitations applicable to a Rule 10b-5 claim is longer than the one provided in section 13. The statute of limitations applicable to a Rule 10b-5 private damage claim provides in pertinent part:

> a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of—

Because the purchaser has a straightforward express cause of action for noncompliance with the exemption from section 5, it seems reasonable to adopt a rule precluding a claim under Rule 10b-5 that is based on a complete failure to make disclosure to a nonaccredited sophisticated investor in a Rule 506(b) transaction.[178] While the Supreme Court has held that an implied claim may be pursued even when the conduct is actionable under an express liability provision,[179] there is no requirement that the SEC maintain the scope of Rule 10b-5 to preserve a claim that parallels a claim under one of the express liability provisions. The SEC has the power to modify its own rules for appropriate reasons.[180] Adopting a safe harbor here will limit the claim to the one specified by Congress. The tardy claimant in particular will not have a Rule 10b-5 fallback.

The safe harbor would provide, "No failure to make a disclosure required solely by any of Rule 506(b)(1), Rule 502(b)(1), Rule 506(b)(2)(ii), or Rule 506(b)(2)(iv) shall be deemed to be a violation of Rule 10b-5."

F. Rule 701

Securities Act Rule 701 provides an exemption from the registration requirement for sales of securities made pursuant to certain compensatory benefit plans.[181] This rule includes a disclosure requirement similar to the one that arises under Rule 506(b). The exemption requires specified disclosures regarding the issuer "if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds \$10 million."[182] This requirement is a condition of the exemption.[183] An issuer might fail to comply with this require-

(1) 2 years after the discovery of the facts constituting the violation; or

(2) 5 years after such violation.

28 U.S.C. § 1658(b) (2018); *see* Merck & Co. v. Reynolds, 559 U.S. 633 (2011) (applying section 1658(b) to Rule 10b-5 private claim for damages).

178. The SEC can bring an enforcement action based on the issuer's noncompliance with section 5. *See, e.g.*, SEC v. Esposito, 260 F. Supp. 3d 79 (D. Mass. 2017).

179. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 387 (1983) ("the availability of an express remedy under Section 11 of the 1933 Act does not preclude defrauded purchasers of registered securities from maintaining an action under Section 10(b) of the 1934 Act").

180. *See infra* Part V.H (discussing the validity of the rules proposed here).

181. 17 C.F.R. § 230.701 (2018), *as amended by* Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act Release 10,520, 83 Fed. Reg. 34940, 34944 (July 24, 2018).

182. Rule 701(e), 17 C.F.R. § 230.701(e). The amendment increased the disclosure threshold from \$5 million to \$10 million, as directed by Congress. *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 507, 132 Stat. 1296, 1363–64 (2018). When the SEC adopted the amendment it also issued a concept release regarding compensatory securities offerings in which it seeks comments on, among other issues, the disclosure requirements imposed by Rule 701. Concept Release on Compensatory Securities Offerings and Sales, Securities Act Release 10,521, 83 Fed Reg. 34958 (July 24, 2018) [hereinafter 701 Concept Release]. The SEC did not there seek any comment on a Rule 10b-5 safe harbor for Rule 701 disclosure failures, such as discussed here.

183. Rule 701(a), 17 C.F.R. § 230.701(a) ("Offers and sales made in compliance with all of the conditions of this section are exempt" from section 5 of the Securities Act.). The SEC recently imposed sanctions on an issuer that failed to comply with this disclosure requirement. *In re* Credit Karma, Inc., Securities Act Release No. 10,469, 2018 WL 1257807 (Mar. 12, 2018).

ment by neglecting, perhaps recklessly, to keep track of the dollar amount of sales made in reliance on the exemption and not recognize that the threshold had been exceeded. As the leading text on exempt transactions explains:

> [T]he [required] disclosure must be provided to all investors before sale, not just those investors who purchase after the threshold has been crossed. . . . In other words, if an issuer believes that its Rule 701 transactions might reach the $5 million [now $10 million] threshold during a 12-month period, it would be wise to provide the additional disclosure items as part of all of the sales. [The SEC has explained] "[i]f disclosure has not been provided to all investors before sale, the issuer will lose the exemption for the entire offering when sales exceed the $5 million threshold."[184]

A Rule 10b-5 safe harbor for the failure to satisfy the disclosure requirement of Rule 701(e) should be adopted, based on the same reasoning for a safe harbor regarding the disclosure requirement imposed by Rule 506(b).[185]

The safe harbor would provide, "No failure to make a disclosure required solely by both Rule 701(a) and the second sentence of Rule 701(e) shall be deemed to be a violation of Rule 10b-5."

G. Exchange Act Section 13(d)

In general terms, section 13(d) of the Exchange Act[186] and the implementing rules[187] require any person, including a group,[188] who has beneficial ownership[189] of more than 5 percent of a class of equity security registered under the Exchange Act to report that status, along with other information prescribed by Schedule 13D,[190] within ten days of crossing the 5 percent threshold. Undis-

184. Hicks, *supra* note 15, § 8.35 (quoting Securities Act Release No. 7,645, 1999 WL 95489, at *5 (Feb. 25, 1999)). The SEC recently reiterated that interpretation, referring to the pre-amendment disclosure trigger:

> In circumstances where the required disclosure is inadvertently not provided to all investors before the $5 million threshold is crossed, issuers may not rely on the exemption. Accordingly, the current structure of the rule results in issuers needing to anticipate, up to 12 months before exceeding the $5 million threshold, the possibility that they may do so, and to supply plan participants with the additional disclosures for that period.

701 Concept Release, *supra* note 182, 83 Fed. Reg. at 34962.

185. *See supra* text accompanying notes 174–80.

186. 15 U.S.C. § 78m(d) (2018).

187. 17 C.F.R. §§ 240.13d-1–13d-102 (2018).

188. *See* Exchange Act § 13(d)(3), 15 U.S.C. § 78m(d)(3) (2018); Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1). The cited rule provides:

> When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of sections 13(d) and (g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons.

Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1).

189. Beneficial ownership is defined in Rule 13d-3(a), 17 C.F.R. § 240.13d-3(a), to be "(1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security."

190. Rule 13d-101, 17 C.F.R. § 240.13d-101.

closed ownership of more than 5 percent of the stock of a reporting company may be a fact that is material to the market for the security. "[T]he purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control."[191] The failure to disclose that information might be argued to be a breach of an affirmative duty to disclose in violation of Rule 10b-5 clauses (a) or (c).

Most reported decisions hold that the company that is the issuer of the securities in question has standing to sue for equitable relief based on the failure of the person(s) acquiring the securities to timely file a Schedule 13D or filing a materially false Schedule 13D.[192] Courts often hold, though not consistently, that any claim by investors for damages sustained because of a materially false Schedule 13D must be brought under section 18(a) of the Exchange Act,[193] because there is no implied cause of action for damages under section 13(d) nor can the plaintiff proceed under Rule 10b-5.[194] Section 18(a) provides a damage claim only where an investor relied on a "statement in any application, report, or document filed pursuant to [the Exchange Act or the rules thereunder which] at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact." Because the statute refers only to reliance on a materially false filing there is no cause of action under section 18(a) based on a *failure* to file a required report.[195] One court, however, has upheld a claim based on all three clauses of Rule 10b-5 for the defendants' *failure* to file a Schedule 13D identifying all the members of a group, as well as filing materially false Schedules 13D.[196] Thus, there is at least potential exposure under Rule 10b-5 for the failure to file a required Schedule 13D.

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191. GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971).

192. *See, e.g.*, Portsmouth Square, Inc. v. S'holders Protective Comm., 770 F.2d 866, 871 n.8 (9th Cir. 1985) ("Every court of appeals but one that has been faced with the question has held that an issuer corporation has standing to seek injunctive relief under section 13(d)." (citing cases)); *see also* Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 60–65 (1975) (holding that an issuer suing for injunctive relief for the delayed filing of a Schedule 13D must establish the traditional elements for injunctive relief).

193. 15 U.S.C. § 78r(a) (2018).

194. *See, e.g.*, Motient Corp. v. Dondero, 529 F.3d 532, 536 (5th Cir. 2008) ("Section 18(a) provides the sole basis for a private right of action for damages resulting from a violation of Section 13(d)."); Sanders v. Thrall Car Mfg. Co., 582 F. Supp. 945, 959–60 (S.D.N.Y. 1983) (holding that because buyers and sellers of securities injured as a result of their reliance on statements filed pursuant to section 13(d) may seek redress under section 18(a), there is no implied private cause of action for damages under section 13(d)), *aff'd*, 730 F.2d 910 (2d Cir. 1984) (per curiam) (adopting district court opinion). *But see* Seagoing Unif. Corp. v. Texaco, Inc., 705 F. Supp. 918, 926–27 (S.D.N.Y. 1989) (recognizing cause of action under Rule 10b-5 based on materially false Schedule 13D). A later decision in the same court rejected this ruling. SEC v. Amster & Co., 762 F. Supp. 2d 604, 614 (S.D.N.Y. 1991).

195. Arnold S. Jacobs, The Williams Act—Tender Offers and Stock Accumulations § 2.88 (2018) ("Section 18(a) creates no private right of action for a failure to file a Schedule 13D, a filing of a Schedule 13D too late, or for certain misleading information on the Schedule 13D cover page. Section 18(a) merely permits suits for damages based on an inaccurate Schedule 13D once it has been filed." (footnotes omitted)).

196. Burt v. Maasburg, No. ELH-12-0464, 2014 WL 1291834, at *16–25 (D. Md. Mar. 28, 2014) ("The failure to file or amend a Schedule 13D, as required, serves as a predicate for liability under § 10(b) and Rule 10b-5(b).").

There are only limited circumstances for an appealing argument that the failure of a single person to file a Schedule 13D on time should be immunized from Rule 10b-5 liability that otherwise might apply.[197] Any investor should know how many shares he owns beneficially, that is, how many shares he has the power to sell or to vote, and in doing the 5 percent calculation the investor is entitled to rely on the company's most recent publicly reported number of shares outstanding.[198] Thus, the decision whether a Schedule 13D must be filed is generally not comparable in uncertainty to the complex, judgmental questions of materiality that underlie some of the rules and proposals discussed earlier.[199]

In some situations, however, it may be difficult to determine who is a member of a group and thus whether a Schedule 13D must be filed at all and by whom. The answers to these questions depend on all of the facts and circumstances of the relationship between or among the putative members of the group. The issue of whether a group existed and, if so, when it was formed, is often the subject of litigation.[200] One case summarized the considerations as follows:

> Whether the requisite agreement exists [to find that there was a group] is a question of fact. The agreement may be formal or informal and may be proved by direct or circumstantial evidence. Moreover, the alleged group members need not be committed to "acquiring, holding, voting, or disposing of equity securities" on certain specified terms, but rather they need only have combined to further a common objective regarding one of the just-recited activities. In short, we must examine the record to determine whether sufficient evidence supports an inference that such an agreement or understanding exists.[201]

Because the decision regarding group membership is based on a complex assessment comparable to that surrounding materiality, and under the time constraint to file no later than ten days after crossing the 5 percent threshold, it is appropriate to shelter putative group members from a Rule 10b-5 claim asserting that all or some of the members of the group failed to file, that is, that the members of the group breached an affirmative duty to disclose. Any safe harbor would not extend to a materially false filing.

Another scenario in the context of the section 13(d) group should be excluded from the reach of Rule 10b-5. An investment adviser who has sole discretion over transactions in a client's account is the beneficial owner of the client's securities because the adviser has the power to sell the securities, even if the adviser does not make the decision on how to vote the securities.[202] If the adviser has multiple clients for whom it has purchased securities of an issuer with a class of securities registered under section 12 of the Exchange Act, the holdings of

197. For one example, see *infra* text accompanying notes 202–05.

198. Rule 13d-1(j), 17 C.F.R. § 240.13d-1(j) (2018).

199. *See supra* Part IV.B (regarding Regulation FD), Part IV.D (regarding Form 8-K), Part V.C (regarding Item 303), and Part V.D (regarding Item 103).

200. *See, e.g.*, 5 Loss et al., *supra* note 86, at 68–73 (discussing cases).

201. Morales v. Quintel Entm't, Inc., 249 F.3d 115, 124 (2d Cir. 2001) (citations omitted).

202. *See, e.g.*, Wellman v. Dickinson, 682 F.2d 355, 365 (2d Cir. 1982) (holding that investment manager with power to dispose of client's securities was beneficial owner for purposes of section 13(d)).

all of those clients would be aggregated—the adviser is the beneficial owner of all of those securities.[203] If that total exceeds the 5 percent threshold, the adviser must file as required by section 13(d).[204] An adviser who recklessly failed to keep accurate track of these disparate holdings might be vulnerable to an action under Rule 10b-5.[205] The safe harbor proposed here would shield that adviser from Rule 10b-5, although not from an SEC enforcement action for noncompliance with Section 13(d).

This proposed safe harbor is different from those proposed in the preceding subsections, as it involves excluding by rule Rule 10b-5 liability for noncompliance with a statutory requirement as distinguished from limiting the potential application of another SEC rule. It is entirely within the power of the SEC, however, to declare that one of its rules does not prohibit noncompliance with a statute. This is accomplished here by, in effect, declaring certain conduct that may violate the law not to be a *per se* unlawful act within the scope of Rule 10b-5. Focusing on clauses (a) and (c) of Rule 10b-5, the proposed safe harbor would deem the failure to file in compliance with section 13(d) not to be "any device, scheme, or artifice to defraud" or "any act, practice, or course of business which operates or would operate as a fraud or deceit." This is very much like what the SEC did in Rule 10b-18, declaring that certain conduct would not

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203. *See* Rule 13d-3(c), 17 C.F.R. § 240.13d-3(c) (2018) ("All securities of the same class beneficially owned by a person, regardless of the form which such beneficial ownership takes, shall be aggregated in calculating the number of shares beneficially owned by such person.").

204. Any person covered by section 13(d) may file a report on Schedule 13G, which requires less information, rather than Schedule 13D, if "[s]uch person has acquired such securities in the ordinary course of his business and *not with the purpose nor with the effect of changing or influencing the control of the issuer*, nor in connection with or as a participant in any transaction having such purpose or effect" and the filing person is among several categories, one of which is an investment adviser registered with the SEC or with a state securities authority. Rule 13d-1(b)(1)(i), (ii)(E), 17 C.F.R. § 240.13d-1(b)(1)(i), (ii)(E) (2018) (emphasis added); *see also* Exchange Act § 13(g), 15 U.S.C. § 78m(g) (2018) (empowering the SEC to prescribe a short form for certain persons otherwise subject to section 13(d)).

The fine points of reliance on and compliance with Schedule 13G are beyond the scope of this article. The main point is that *some* filing must be made in compliance with section 13(d) when an investment adviser becomes the beneficial owner of more than 5 percent of a covered class of security as a result of acquiring the security in accounts over which the adviser has investment discretion to sell the securities. A client of the adviser has an independent obligation to report if its *own* beneficial ownership exceeds 5 percent. As explained by the SEC Staff:

> Question: A security holder that owns greater than five percent of a voting class of equity securities registered under Section 12 of the Exchange Act has delegated all authority to vote and dispose of its stock to an investment advisor. Must the security holder still continue to report beneficial ownership of the shares?
>
> Answer: Yes, assuming the security holder retains the right under the contract to rescind the authority granted to the investment advisor and regain investment or voting power over the shares within 60 days. See Rule 13d-3(d)(1) and Example 11 in Exchange Act Release No. 13,291 (February 24, 1977).

SEC Compliance and Disclosure Interpretations, Question 105.04, U.S. SEC. & EXCHANGE COMMISSION (Sept. 14, 2009), https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.

205. *See supra* note 196 (citing case where court applied Rule 10b-5 to a failure to file required schedule under section 13(d)).

be a violation of the prohibition on manipulation in section 9(a)(2) of the Exchange Act.[206]

The safe harbor would provide, "(a) No failure of a group to file an initial Schedule 13D or Schedule 13G shall be deemed to be a violation of Rule 10b-5. (b) No failure of an investment adviser, as that term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940, to file an initial Schedule 13D or Schedule 13G where the filing was required solely as a result of the investment adviser's beneficial ownership of securities held in accounts of persons advised by the investment adviser shall be deemed to be a violation of Rule 10b-5."[207]

H. Validity of the Proposed Safe Harbors

No decision has been found invalidating any of the safe harbors described in Part IV.[208] Nevertheless, it would be a fool's errand to propose regulatory action that would exceed the SEC's power. The most thorough context in which to assess the validity of the rules proposed here is to address the one that would apply to cases that have been litigated, the proposed safe harbor for the MD&A provision regarding known trends discussed in Part III.B.

A rule that stated that a failure to file information required by Item 303(a)(3)(ii) would be deemed not to be a violation of Rule 10b-5 would preclude claims such as those asserted in, for example, *Leidos*, except to the extent that the claim could be characterized as asserting a half-truth in violation of Rule 10b-5(b).[209] Thus, while it remains the SEC's position that failure to comply with a reporting requirement under section 13(a) or 15(d) of the Exchange Act is a breach of duty that could provide the basis for a claim under Rule 10b-5,[210] a rule that renders noncompliance with a *specific* requirement not a *per se* violation of Rule 10b-5 would eliminate only the Rule 10b-5 claim for a failure to make *that* required disclosure. That is, the rule proposed here would provide only that the failure itself to make a disclosure otherwise required by Item 303(a)(3(ii) would be deemed not a deceptive act in violation of Rule 10b-5.

The SEC has the power under section 10(b)—the authority for Rule 10b-5—to adopt rules prohibiting "deceptive device[s] . . . as necessary or appropriate in the public interest or for the protection of investors." It has exercised this power to define concepts applicable to the law of insider trading in violation

206. *See supra* text accompanying notes 85–86.

207. The qualifier "solely" is intended to exclude from part (b) of the safe harbor the situation where the clients of the adviser are otherwise a group, for example, where the clients are acting in concert. Of course, the safe harbor in part (a) would afford the group a safe harbor from Rule 10b-5 in any event.

208. The Rule 13a-11(c) safe harbor for the failure to file a required Form 8-K was applied in Bank of Am. Corp. Sec., Derivative & Emp. Ret. Income Sec. Act (ERISA) Litig., No. 09 MD 2058(PKC), 2011 WL 3211472, at *10 (S.D.N.Y. July 29, 2011) ("the plaintiffs cannot allege that the failure to comply with Item 1.01(a) is, standing alone, sufficient to state a claim under Section 10(b) and Rule 10b-5").

209. *See, e.g.*, *supra* text accompanying note 137 (discussing concept of half-truth under Rule 10b-5).

210. *See supra* text accompanying notes 96–98 (discussing SEC's position expressed in adopting Regulation FD and in the Government's brief in *Leidos*).

of Rule 10b-5.[211] While these rules arguably had the effect of expanding the reach of the law or limiting defenses,[212] nothing precludes the SEC from limiting or clarifying the scope of Rule 10b-5 itself, as it did in adopting the safe harbor in Rule 10b-18.[213] As the SEC explained in that context, "The issuer or other person will not incur liability under the anti-manipulative provisions of section 9(a)(2) or 10(b) (and Rule 10b-5 thereunder) if purchases are effected in compliance with the limitations contained in the safe harbor."[214]

The SEC is the master of what is prohibited by rule pursuant to section 10(b), so long as it does not prohibit more than is permitted by that authority.[215] The existing Rule 10b-5 safe harbors discussed in this article were an exercise of the SEC's authority under section 10(b).[216] The safe harbors proposed here would also be predicated upon that authority to identify conduct deemed *not* to be a *per se* violation of Rule 10b-5.

Finally, any consideration of the validity of agency action, especially in the context of rulemaking, must take into account *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*[217] The first test in assessing the validity of an agency rule under *Chevron* is that if a statute includes an explicit definition, the court must follow that definition.[218] This criterion does not apply here, not only because section 10(b) does not define deceptive conduct but, more to the point, the statute empowers the SEC to decide what deceptive conduct to prohibit and what not to prohibit. The SEC need not prohibit all deceptive conduct, though what it prohibits must be deceptive or manipulative within the scope of section 10(b).

The next step under *Chevron* is to determine if the rule is a "permissible construction of the statute."[219] "The Supreme Court has clarified that a 'prior judicial construction of a statute trumps [a later] agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its

211. *See* Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2018) (defining the phrase "on the basis of" when used in claims alleging that someone traded on the basis of material nonpublic information); Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2018) (specifying situations involving "duties of trust or confidence" for purposes of the misappropriation theory of insider trading).

212. *See, e.g.*, Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 Bus. Law. 913, 920–23, 943–49 (2007) (questioning the validity of Rule 10b5-1 in certain respects).

213. *See supra* text accompanying notes 84–86; *see also supra* Part V.G (discussing validity of proposed Rule 10b-5 safe harbor applicable to section 13(d)).

214. 10b-18 Adopting Release, *supra* note 84, 47 Fed. Reg. at 53333. *See also supra* text accompanying notes 84–86 (describing Rule 10b-18). The SEC noted that this safe harbor did not provide a shield for deceptive conduct. 10b-18 Adopting Release, *supra* note 84, 47 Fed. Reg. at 53334 n.5.

215. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213 (1975) (ruling that the scope of Rule 10b-5 "cannot exceed the power granted the Commission by Congress under § 10(b)").

216. *See* FD Adopting Release, *supra* note 90, 65 Fed. Reg. at 51738 (specifying section 10 as one of the statutory bases for the adoption of Regulation FD); Regulation G Adopting Release, *supra* note 109, 68 Fed. Reg. at 4832 (specifying section 10 as one of the statutory bases for the adoption of Regulation G); 2004 8-K Adopting Release, *supra* note 123, 69 Fed. Reg. at 15613 (specifying section 10 as one of the statutory bases for the adoption of the amendments to Form 8-K and related provisions).

217. 467 U.S. 837 (1984).

218. Digital Realty Trust, Inc. v. Somers, 138 S. Ct. 767, 776–77 (2018) (invalidating SEC rule because it employed a definition that was inconsistent with the one prescribed by Congress).

219. *Chevron*, 467 U.S. at 843.

construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.'"[220] While the proposals here do not attempt to override the caselaw on whether a breach of a disclosure requirement is actionable under Rule 10b-5, which in any event is not consistent,[221] the rules proposed here will narrow the scope of deceptive conduct.

The final component of the *Chevron* test is whether the agency action is "arbitrary, capricious, or manifestly contrary to the statute."[222] "The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding."[223] Two considerations demonstrate that the safe harbors proposed here, including the one for Item 303(a)(3)(ii) by way of example, satisfy this step. First, the SEC has adopted safe harbors of the type proposed here since the adoption of Regulation FD eighteen years ago, without apparent objection, much less an overturning of a rule. Second, the factors that support the rules proposed here are grounded in legitimate practical considerations that are consistent with the stated rationales for the existing rules.[224]

For all of these reasons, the rules proposed here should survive any challenge based on *Chevron*.[225]

I. Other Affirmative Disclosure Obligation Candidates for a Rule 10b-5 Safe Harbor

Many items in Regulation S-K unambiguously require the reporting company to include *something* responsive to the item in the applicable form.[226] Thus, a complete omission would be a failure that does not deserve any protection as the statement that there is nothing to report would be a misrepresentation. Scholars and practitioners in this field with a different perspective, however, may identify other candidates for protective treatment.

220. United States v. McGee, 763 F.3d 304, 312 (3d Cir. 2014) (quoting Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982 (2005) (upholding SEC Rule 10b5-2)).

221. *See supra* Part III.B.

222. *Chevron*, 467 U.S. at 843.

223. *Id.* at 843 n.11.

224. *See supra* Parts IV.B, D.

225. This is wholly apart from any question about the continued vitality of *Chevron* itself. In an opinion concurring with the opinion he wrote for a three-judge panel when sitting on the Tenth Circuit, then Judge now Justice Gorsuch offered these observations about *Chevron*: "*Chevron* . . . permits executive bureaucracies to swallow huge amounts of core judicial and legislative power and concentrate federal power in a way that seems more than a little difficult to square with the Constitution of the framers' design. Maybe the time has come to face the behemoth." He also said: "Not only is *Chevron's* purpose seemingly at odds with the separation of legislative and executive functions, its effect appears to be as well." Gutierrez-Brizuela v. Lynch, 834 F.3d 1142, 1149, 1154 (10th Cir. 2016) (Gorsuch, J., concurring); *see also* SAS Inst., Inc. v. Iancu, 138 S. Ct. 1348, 1358 (2018) (Gorsuch, J., writing for the majority) ("whether *Chevron* should remain is a question we may leave for another day").

226. *See supra* note 168 (discussing Rule 12b-13).

J. Safe Harbor Protections from Other Liability Provisions

Rule 10b-5 is not the only provision that can give rise to private damage liability under the securities laws. Several sections of the statutes under consideration here, in addition to section 18(a), expressly provide for damage liability, in contrast to the implied liability under Rule 10b-5.

Sections 11 and 12(a)(2) of the Securities Act expressly provide for liability for deceptive disclosures in certain transactions, section 11 in the case of a registered offering[227] and section 12(a)(2) in the case of sales by means of a false or misleading prospectus[228] where "'prospectus' is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder."[229] At one time, courts also implied a cause of action for a violation of section 17(a) of the Securities Act; this is no longer a viable claim.[230]

Congress spoke expansively in Section 11, using language that does not appear in the other liability sections. Section 11 imposes liability for the "omi[ssion] to state a fact required to be stated" in the registration statement.[231] Thus, an SEC rule providing that the omission altogether of some required disclosure would *not* be actionable under section 11 would essentially seek to undo entirely that unique aspect of section 11. This is beyond the power of the SEC under section 19 of the Securities Act to "make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title, including rules and regulations . . . defining accounting, technical and trade terms used in this title."[232]

Section 12(a)(2) applies when a statement "includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." This parallels only clause (b) of Rule 10b-5; it does not have the broad scope of subsections (a) and (c) of Rule 10b-5, which prohibit "any device, scheme, or artifice to defraud" and "any act, practice, or course of business which operates or would operate as a fraud or deceit." Thus, section 12(a)(2)

227. Section 11(a) provides, "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security" may sue specified persons involved in the offering. 15 U.S.C. § 77k(a) (2018).

228. Section 12(a)(2) provides that a buyer may sue the seller of securities where the sale was made "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." *Id.* § 77*l*(a)(2).

229. Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995) (construing the scope of section 12(a)(2)). It is generally held that liability for oral statements under section 12(a)(2) lies only where the deceptive oral statement is in a transaction where a "prospectus," as that term was applied in *Gustafson*, would be actionable. *Id.* at 567–68 (citing cases).

230. 9 Loss et al., *supra* note 86, at 577–78 ("The more recent trend among the circuits . . . is decisively against implying a private cause of action under § 17(a)." (footnote omitted)).

231. *See supra* text accompanying notes 64–65.

232. Exercising its power to define terms, in Securities Act Rule 176, 17 C.F.R. § 230.176 (2018), the SEC identified "relevant circumstances" for interpreting several phrases in section 11. The SEC did not thereby change the meaning of the statute.

does not reach the pure omission,[233] and so there is no need for a rule to remove from the scope of section 12(a)(2) the entire failure to make some required disclosure, even if such a rule were valid.

As noted earlier, section 18(a) imposes liability for documents actually filed with the SEC under the Exchange Act.[234] Section 18(a) thus does not reach the entire failure to disclose information required to be included in an Exchange Act filing, which is the focus of the proposed safe harbors here. The utility of section 18(a) is in any event limited by the fact that a claim based on section 18 is, at best, very difficult to pursue as a class action, because it expressly requires each class member to prove actual reliance on the false document.[235]

Accordingly, there is no apparent need for protection, or perhaps even SEC power, to exclude omissions *per se* from the scope of the express deception liability provisions of the Securities Act or of the Exchange Act.

VI. Conclusion

The SEC has adopted several rules that shield the failure to file a report required by specific disclosure requirements from *per se* liability under Rule 10b-5, including from an SEC enforcement action under that rule. Consistent with the rationale of those safe harbors, several other important SEC express disclosure requirements under the Exchange Act merit similar protection. The SEC should move to implement the proposals made in this article.[236]

233. *See* 9 Loss et al., *supra* note 86, at 261–62 ("§ 12(a)(2) does not impose liability for omissions *per se*" unless there was "an affirmative duty to speak in special situations," such as a fiduciary relationship).

234. *See supra* text accompanying notes 193–95.

235. *See* Safety-Kleen Corp. Bondholders Litig., No. 3:00-1145-17, 2004 WL 3115871, at *5 (D.S.C. Mar. 19, 2004) (noting split in authority and certifying class claims under section 18(a)). The court later decertified the section 18(a) class. Safety-Kleen Corp. Bondholders Litig., No. 3:00-1145-17, 2004 WL 3115870, at *10 (D.S.C. Nov. 1, 2004) ("The uncontradicted evidence has shown that the plaintiffs did not read or rely on any alleged misstatements . . . . Plaintiffs have not demonstrated that there is any commonality in their reliance."); *see also* Marc I. Steinberg et al., Securities Litigation Law, Policy, and Practice 472 (2016) ("In light of the fact that plaintiffs asserting Section 18(a) claims must establish actual reliance, that Section is not usually the basis for any class action.").

236. No matter how compelling the case for more safe harbors made here, there should be no expectation that these proposals will soon find their way onto the SEC's heavy rulemaking agenda. *See, e.g.*, Securities and Exchange Commission Regulatory Flexibility Agenda, 83 Fed. Reg. 2022 (Jan. 12, 2018) (listing rulemaking priorities of the chairman of the SEC). While the SEC has proposed revisions to Regulation S-K, none of them pertains to the specific items addressed in this article. *See* FAST Act Modernization and Simplification of Regulation S-K, Securities Act Release No. 10,425, 82 Fed. Reg. 50988 (Nov. 2, 2017); *see also Agency Rule List—Spring 2018*, Reginfo.gov, https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235 (last visited Sept. 27, 2018) (listing the stage of each of the many rulemakings pending at the SEC, including those for the long term).