Triggers and Risks

Whether, When, What and Where to Disclose Under S-K Item 105

Lessons from Alphabet and Facebook

By J. Anthony Terrell

February 1, 2025

BRACEWELL

TABLE OF CONTENTS

I. Introduction

Having granted a Writ of Certiorari to review the decision of the United States Circuit Court of Appeals for the Ninth Circuit (the "Ninth Circuit") in *Amalgamated Bank et al v. Facebook, Inc. et al (In re Facebook, Inc. Securities Litigation*), 87 F.4th 934 (9th Cir. 2023) ("*Facebook*")[1], and having heard oral argument by the parties and *amici curiae*, on November 22, 2024 the United States Supreme Court issued an unusual decision -- surprising to some but perhaps not to others. The Court dismissed the case, stating only that the Writ of Certiorari had been "improvidently granted". (604 U.S. 4 (2024)

Facebook involved, among other things, the question of whether the discussion of a risk can be misleading if it does not disclose previous occurrences of that risk or of events that increase the probability of that risk. Facebook did not make such disclosure, and the Ninth Circuit held that the plaintiffs had adequately pleaded a cause of action under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") and Rule 10b-5(b) thereunder on the grounds that the omission of such information rendered its risk discussion misleading. Facebook asked the Supreme Court to review the judgment of the Ninth Circuit on the following somewhat oddly posed question:

> Are risk disclosures false or misleading when they do not disclose that a risk has materialized in the past, even if that past event presents no known risk of ongoing or future business harm?

A similar, although not identical, question was involved in the Ninth Circuit's previous decision in *Rhode Island v. Alphabet, Inc.* (*In re Alphabet, Inc. Securities Litigation*), 1 F.4th 687 (9th Cir. 2021) ("*Alphabet*"). Interestingly, following the decision of the Ninth Circuit, the Supreme Court denied Alphabet's Petition for a Writ of Certiorari.

The clear-cut answer to the question raised in both *Alphabet* and *Facebook* seems to be that, sometimes, depending on the circumstances and the language of the risk factor, some historical information may be necessary to qualify the discussion of a risk, at least somewhere in the disclosure document. Analysis of both *Alphabet* and *Facebook* is necessary to attempt an understanding of this issue under the law of the Ninth Circuit and, indeed, after the non-decision of the Supreme Court in *Facebook*, presumably the law of the land. While these cases raised a multitude of collateral issues, especially in the lower courts, this note will focus on the specific question directed to the Supreme Court.

II. Alphabet Litigation

A. Background

In *Alphabet*, the Ninth Circuit held, under the particular facts of that case, that generic risk factors can themselves be misleading statements when not accompanied by disclosures that the very risks being warned of had in fact come to fruition. The omission by Alphabet, Inc. (the corporate parent of Google, "Alphabet") of disclosure that the risk that was discussed had actually occurred constituted an actionable omission "necessary to make the statements made … not misleading" under Section 10(b) of the 1934 Act and Rule 10b-5(b) promulgated thereunder by the Securities and Exchange Commission (the "SEC"). (See Rule 10b-5(b)). The background of this decision is required for a full understanding of its import.

Alphabet's Annual Report on Form 10-K for the year ended December 31, 2017 (the "Alphabet 10-K"), filed in February 2018, contained a litany of risk factors relating to the possible release of the personal information of customers and users, including the following:

- [P]rivacy concerns relating to our technology could damage our reputation and deter current and potential users or customers from using our products and services.

- If our security measures are breached resulting in the improper use and disclosure of user data … our products and services may be perceived as not being secure … users and customers may curtail or stop using our products and services…

- Any systems failure or compromise of our security that results in the release of our users' data … could seriously harm our reputation and … business…. We expect to continue to expend significant resources to maintain state-of-the-art security protections that shield against theft and security breaches.

- We experience cyber attacks of varying degrees on a regular basis. Our security measures may also be breached due to employee error … system errors or vulnerabilities … Such breach or unauthorized access … could result in significant legal and financial exposure … and a loss of confidence in the security of our products and services that could potentially have an adverse effect on our business.

(Alphabet 10-K at 10-11)

In March and April 2018, before the Quarterly Report on Form 10-Q for the first quarter was filed, Alphabet "discovered a software glitch in the Google+ social network that had existed since 2015 (referred to in the [Alphabet Complaint (as defined below)] as the 'Three-Year Bug')". (*Alphabet,* 1 F.4th at 695), This glitch enabled third-parties to collect "certain users' profile data even if those users had relied on Google's privacy settings to designate such data as nonpublic. The exposed private profile data included email addresses, birth dates, gender, profile photos, places lived, occupations, and relationship status."(*Id.*). These data did not include sensitive information like social security numbers or financial or medical information. (*Id.* at 704)

After the Three-Year Bug was discovered, Alphabet investigated and produced an internal report (the "Privacy Bug Memo") on the Three-Year Bug and other security vulnerabilities that the investigation had revealed. The report concluded, among other things, that "disclosure of these security issues 'would likely trigger "immediate regulatory interest" and result in defendants "coming into the spotlight …." (*Id.* at 696). Thereupon, Alphabet's management "chose a strategy of nondisclosure … to conceal the existence of the Three-Year Bug and other security vulnerabilities … 'to avoid any additional regulatory scrutiny'" and shut down the Google+ platform, all before filing the first quarter 10-Q in late April 2018. (*Id.*)

Alphabet's Quarterly Reports on Form 10-Q for the first and second quarters of 2018 (the "Alphabet 10-Qs") stated that there had been no material changes to Alphabet's risk factors since the Alphabet 10-K.

Unfortunately for Alphabet and its management, the Three-Year Bug and the nondisclosure decision were leaked and were the subject of an article in *The Wall Street Journal* published on October 8, 2018. The market price of Alphabet's common stock suffered significant losses on October 8, 9 and 10, 2018. (*Id.* at 697)

B. District Court

Promptly after the publication of *The Wall Street Journal* article, various parties filed securities fraud actions in the United States District Court for the Northern District of California, Oakland Division. The various cases were consolidated, with the State of Rhode Island, Office of the Rhode Island Treasurer on behalf of the Employees' Retirement System of Rhode Island ("Rhode Island") being designated the lead plaintiff and filing a consolidated complaint (the "Alphabet Complaint") (Case No. 4:18-cv-06245-JSW). Rhode Island alleged, among other things, that, by omitting disclosure of the Three-Year Bug and the consequent exposure of personal information to third parties, Alphabet violated Section 10(b) of the 1934 Act and Rule 10b-5 thereunder because, among other things, such omission rendered misleading the statements made in the generic risk factors stated in the Alphabet 10-K. It is noteworthy that Rhode Island did not allege exposure of personal information to, or any misuse of such information by, any particular third party.

Alphabet moved to dismiss, arguing, among other things, that:

- the discovery of the Three-Year Bug, without the disclosure thereof, did not render the stated risk factors false or misleading as warnings of problems that may occur in the future;

- the Three-Year Bug had been discovered and remedied prior to the time the statements were made in the Alphabet 10-Qs, so that, at the time these 10-Qs were filed, there was no such bug or vulnerability to disclose;

- a problem that existed only in the past and does not exist in the present cannot, if undisclosed, render risk disclosures misleading: reasonable readers are unlikely to infer anything about the *past* from a statement "inherently" about the *future*;

- the risk factors stated in the Alphabet 10-K were adequate to warn investors of potential system errors or vulnerabilities and related privacy concerns;

- Rhode Island failed to plead facts showing that the Three-Year Bug was material;

- the personal information that was exposed by the Three-year Bug" was not inherently sensitive in nature;

- there was not a single, identified user whose information was actually accessed or misused; and

- there were no allegations that the bug was material to Google's business or that it materially affected earnings.

(Motion to Dismiss at 7-13)

On February 5, 2020, the District Court granted (N.D.CA. No. 18-cv-06245-JSW, DKT. No. 82, 2020) Alphabet's Motion to Dismiss *(Id*. at DKT. No. 71, 2019). The court apparently adopted all of Alphabet's arguments, stating cryptically

> There is no support for the position that a remediated technological problem which is no longer extant must be disclosed in the company's future-looking disclosures. (District Court Order at 5)

The District Court also noted in relevant part, in agreement with Alphabet, that Rhode Island did not show that the Three-Year Bug was material to Alphabet's overall business or that it had a material effect on its earnings. (District Court Order at 6)

C. Ninth Circuit

Rhode Island appealed the dismissal by the District Court to the Ninth Circuit (Case No. 20-15638). Rhode Island and Alphabet repeated, and enhanced, substantially the same arguments that they had made in the District Court proceeding. On June 16, 2021, the Ninth Circuit reversed the District Court finding, among other things, that discussion of a risk can be misleading if the risk has actually "come to fruition" but is not disclosed:

> The complaint also plausibly alleges that Alphabet's omission was misleading. Risk disclosures that "speak[ ] entirely of as-yet-unrealized risks and contingencies" and do not "alert[ ] the reader that some of these risks may already have come to fruition" can mislead reasonable investors. … [W]e [have] explained that a 10-Q statement that warned of "the risks of product liability claims in the abstract" was misleading because it failed to disclose that the risk had already come to fruition. *Siracusano v. Matrixx Initiatives, Inc.*, 585 F. 3d 1167, 1181 (9th Cir. 2009) … *aff'd*, 563 U.S. 27 … (2011). Even more recently, we held that a company's warning in its Form 10-Q that share prices "might" be affected by announcements of study results that "may" be inconsistent with interim study results was misleading because the company "allegedly knew already that the 'new data' revealed exactly that." *Khoja* [*v. Orexigen Therapeutics, Inc.*], 899 F.3d [988] at 1015-16 [(9th Cir. 2018)] … As in these cases, the complaint plausibly alleges that Alphabet's warning in each Form 10-Q of risks that "could" or "may" occur is misleading to a reasonable investor when Alphabet knew that those risks had materialized. (*Alphabet* at 703, 704)

The Ninth Circuit's primary finding was amplified by its findings that:

- the detection and disclosure of the Three-Year Bug and the other vulnerabilities mentioned in the report themselves created further risks, such as the risk of concerns on the part of users as to the privacy of their personal information, which, in turn, could damage the company's reputation and adversely affect [its] operating results, as well as the risk of increased regulatory scrutiny, all consistent with the warnings in the Alphabet 10-K; and the omission of the facts creating these additional risks rendered misleading the statements of risk that were actually made (*Alphabet* at 702, 703); and

- the fact that the personal information that was exposed did not contain "sensitive" information did not render the Three-Year Bug or the other vulnerabilities not material because the vulnerability to cybersecurity incidents may itself be important to reasonable investors regardless of the nature of the exposed information; the court noted the substantial decline in the Alphabet's stock price following the publication of *The Wall Street Journal* article, even without a release of sensitive information, as support for the allegation of materiality. (*Id*. at 704,705)

D. Petition for Certiorari

Alphabet filed with the Supreme Court of the United States a Petition for a Writ of Certiorari (Case No. 21-594) to review the judgment of the Ninth Circuit on the following specific question:

> whether the "risk factors" disclosed in a securities filing must disclose only future risks or must also disclose whether a risk has come to fruition in the past. (Petition at (i))

Alphabet, of course, argued that the answer is "no":

> A "risk" is the *possibility* of a future harm or loss. It captures what might occur, not what has occurred. And because a reasonable investor understands that a "risk" captures the future and does not summarize the past, omitting a past event from the "risk factor" section of a securities filing is not misleading. (Petition at 4)

Alphabet made several arguments in support of its Petition;

- there is a split among six courts of appeals on the question at issue (Petition at 15-21).

- in any event, the decision of the Ninth Circuit was wrong, arguing that "[a] risk is something that might occur in the future … not something that has already occurred in the past" (Petition at 21); and that "no reasonable investor would expect a risk disclosure statement to discuss past events. A reasonable investor would thus understand that a risk disclosure serves to identify and disclose a potential issue that could arise in the future. And 'a reasonable investor would be unlikely to infer anything regarding the current state of a corporation's compliance, safety, or other operations from a statement intended to educate the investor on future harms'". (Citing *Bondali v. Yum! Brands, Inc.*, 620 F. App'x 483, 491 (6th Cir. 2015)) (Petition at 25)

- "Section 10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information. Disclosure is required … when necessary 'to make the statements made, in the light of circumstances under which they were made, not misleading'". (Citing *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44 (2011)) (quoting Rule 10b-5(b) in part) (Petition at 22)

- the statements as to future risks made in Alphabet's risk factors were correct, and the omission therefrom of past events did not make such statements misleading. (Petition at 27)

Rhode Island's Brief in Opposition stated its position that the decision of the Ninth Circuit was correct and presented no issue warranting review by the Supreme Court, arguing that

- upon close review of their decisions, there is no split among the circuit courts. (Brief in Opposition at 27-29)

- Alphabet's position is that the omission of disclosure of past events from a discussion of risk factors can never be materially misleading to a reasonable investor. Such a bright line rule is inapposite since under Rule 10b-5 disclosure is required when necessary to make the statements that are made not misleading in the light of the circumstances under which they were made. (Brief in Opposition at 13)

- Thus, whether disclosure of past events is necessary "depends on the circumstances" … "[W]hen a speaker omits facts that 'conflict with what reasonable investor would take away from the statement itself', the statement may be misleading." (Citing *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175 ("*Omnicare*"), at 188-189) (Brief in Opposition at 14)

- Accordingly, the statements in the Alphabet 10-Qs to the effect that there had been no material changes to Alphabets' risk factors from those disclosed in the Alphabet 10-K, made after discovery of the Three-Year Bug and other vulnerabilities, were misleading. "That statement left reasonable investors with the false impression that Google's data-security risk profile had remained largely the same when it had dramatically changed. Under these circumstances, the Ninth Circuit correctly concluded that 'the omission of any mention of the Three-Year Bug or the other security vulnerabilities made the statements in each Form 10-Q materially misleading to a reasonable investor.'" (Brief in Opposition at 16)

- "[t]he issues identified in the Privacy Bug Memo were present 'risks' under any definition of the term. Under the circumstances, these ongoing issues involved 'the possibility of loss' even after Google programmers fixed some of Google+'s faulty code. … This made [Alphabet's] boilerplate risk disclosures misleading 'in the light of the circumstances under which they were made.'" (Brief in Opposition at 21-22)

The U.S. Chamber of Commerce, the Securities Industry and Financial Markets Association and the Business Roundtable, as *amici curiae*, jointly filed a brief in support of Alphabet's Petition for Certiorari. Among other things, the *amici* argued that:

- "[n]o reasonable investor would consult a forward-looking risk disclosure to understand a company's past or current operations". (Brief of *Amici Curiae* at 12)

- [r]isk disclosures … are inherently *prospective* in nature. They warn an investor of what harms *may* come to their investment. They are not meant to educate investors on what harms are currently affecting the company". (Citing *Bondali*, *supra*, at 491) (Brief of *Amici Curiae* at 12)

These *amici* also pointed out that Alphabet had even warned that "[w]e experience cyber-attacks of varying degrees on a regular basis" and "[i]f and actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose users and customers". (Brief of *Amici Curiae* at 12)

On March 7, 2022, the Supreme Court denied the Petition for a Writ of Certiorari, thus leaving intact the decision of the Ninth Circuit in *Alphabet*.

III. Facebook Litigation

A. Background

As recited by the Ninth Circuit, users of the Facebook social media platform input personal information and share certain content with other users. Facebook collects data from its users and uses such data for various purposes. In addition, third parties whose websites are integrated into the Facebook platform, may access a user's data and list of "friends" when the user engages with the third party's services on the Facebook platform.

In 2015, *The Guardian* reported that Cambridge Analytica, a British political consulting firm, had acquired user data of over thirty million Facebook users (including personality scores derived therefrom for about 250,000 of such users) from an individual to whom Facebook had granted access for academic purposes and had used this information to help Ted Cruz's presidential primary campaign. Following the article in *The Guardian*, Facebook announced that it was "'carefully investigating' the situation, that misusing user data was a violation of Facebook's policies and that the Company would 'take swift action' against third parties found to have misused Facebook users' data". Facebook asked Cambridge Analytica to delete the data, and in January 2016 Cambridge Analytica agreed to delete the personality score data. In 2016, *The Washington Post* reported that Cambridge Analytica continued to use data to benefit Donald Trump's presidential campaign. There was no significant market reaction to either the 2015 article in *The Guardian* or the 2016 article in *The Washington Post*.

In February 2017, Facebook filed its Annual Report on Form 10-K for 2016 (the "Facebook 10-K"), which contained a litany of risk factors relating to the possible disclosure and misuse of user data, but without any disclosure of the Cambridge Analytica problem.

In March 2018, *The New York Times* and *The Guardian* published articles to the effect that Cambridge Analytica had not destroyed all Facebook users' data and had used analyses of such data to benefit the Trump campaign. Following such reports and further adverse publicity, Facebook's shares suffered significant losses, particularly in March and July of 2018.

See *Facebook*, 87 F.4th at 943-946.

B. District Court

Commencing in March 2018, Facebook shareholders instituted class action lawsuits against Facebook and certain executive officers in the United States District Court for the Northern District of California, San Jose Division. An amended and consolidated complaint (the "FAC") was filed on October 15, 2018, with Amalgamated Bank being designated lead plaintiff. The FAC alleged various violations of Sections 10(b), 20(a) and 20A of the 1934 Act and Rule 10b-5 thereunder, specifying various false or misleading statements falling into three general categories: (1) statements in the "Risk Factors" section of Facebook's Annual Report on Form 10-K for the year 2016 (the "Facebook 10-K"), (2) statements regarding Facebook's investigation into Cambridge Analytica's 2015 misconduct and (3) statements regarding the control Facebook's users have over their data on the Facebook platform. The FAC was dismissed with leave to amend by the District Court on September 25, 2019 for a variety of reasons including without limitation failure to meet the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). This note will focus on the alleged false or misleading risk factors which were the subject of the Writ of Certiorari granted by the Supreme Court.

Following the dismissal of the FAC, Amalgamated Bank filed its Second Amended Complaint (the "SAC") on November 15, 2019. In the SAC, Amalgamated Bank again alleged that several of the stated risk factors were false or misleading and omitted material facts and, therefore, were actionable under Rule 10b-5. Like the FAC, the SAC argued in part that many risks were presented as being merely hypothetical risks. (SAC at 114). In its order dismissing the SAC, issued on August 7, 2020 (the "Second Dismissal"), the District Court, for the benefit of the readers of its decision, reorganized and numbered the various misleading statements alleged by Amalgamated Bank. These statements included several statements of business risk set forth in the Facebook 10-K, some of which are set forth below (as so reorganized and numbered):

> **Statement 22**
>
> Security breaches and improper access to or disclosure of our data or user data, or other hacking and phishing attacks on our systems, ***could*** harm our reputation and adversely affect our business.
>
> **Statement 23**
>
> Any failure to prevent or mitigate security breaches and improper access to or disclosure of our data and or [sic] user data ***could*** result in the loss or misuse of such data, which could harm our business and reputation and diminish our competitive position.
>
> **Statement 24**
>
> We provide limited information to … third parties based on the scope of services provided to us. However, ***if*** these third parties or developers fail to adopt to adequate data security practices … our data or our users' data may be improperly accessed, used, or disclosed.
>
> **Statement 25**
>
> Although ***we have developed systems and processes that are designed to protect our data and user data, to prevent data loss and to prevent or detect security breaches***, we cannot assure you that such measures will provide absolute security.
>
> **Statement 26**
>
> **If** we fail to retain existing users or add new users, or if our users decrease their level of engagement with our products, our revenue, financial results, and business may be significantly harmed ... ***If people do not perceive our products to be useful, reliable, and trustworthy, we may not be able to attract or retain users or otherwise maintain or increase the frequency and duration of their engagement ....***

(Second Dismissal at 12-13)

The District Court applied a technical analysis to these risk factors, noting that "[f]or a risk disclosure to be false or misleading, a plaintiff must allege facts indicating that, when the risk factor statement was made, the *risk warned of* was 'already affecting' the defendant." (emphasis added). As authority for this proposition, the District Court noted:

> *Williams v. Globus Medical Inc.*, 869 F.3d 235 (3d Cir. 2017) [(“*Williams*”)] is instructive. There, the relevant risk disclosure warned that “if any of our independent distributors were to cease to do business with us, our sales could be adversely affected.” *Id.* at 242. The plaintiffs argued that this statement was misleading because the defendants failed to warn investors that they had in fact lost an independent distributor. *Id.* at 241. The court disagreed. The risk warned of was the risk of adverse effects on sales, not the loss of independent distributors generally. *Id.* The risk at issue thus only materialized if sales were adversely affected at the time the risk disclosures were made. *Id*. Accordingly, because the plaintiffs failed to allege that the company’s sales were adversely affected by the decision to terminate the distributor, the risk disclosure was not misleading and the defendants’ duty to disclose was not triggered. *Id.* at 243.

(Second Dismissal at 41)

The District Court then applied this principle to certain of the risk factors alleged to be misleading. “The relevant risks discussed in **Statements 22, 23, 25, and 26** are reputation, business, or competitive harm, *not* improper access to or the disclosure of user data. Plaintiffs do not allege that, at the time the risk disclosure was made, the Cambridge Analytica scandal was harming Facebook’s reputation, business, or competitive position. Nor can they. At the time these risk disclosures were made in February 2017, both Kogan’s and Cambridge Analytica’s misuse of user data were matters of public knowledge (with no alleged harm to Facebook’s business, reputation, or competitive positions) … Accordingly, **Statements 22, 23, 25, and 26** were not misleading because the potential risks presented therein were not yet ‘affecting’ Facebook.” (Second Dismissal 41-42)

As to the risk factor that warned of the improper use or disclosure of user data, while this risk had clearly come to fruition at the time the risk disclosure was made, the District Court found that “the misuse of Facebook user data was already public knowledge, and had been so for more than a year … Investors therefore had all of the information they needed to evaluate **Statement 24** – because the risk of data misuse and loss had already been realized, investors would not have been misled as to this risk.” (Second Dismissal at 42). The District Court also noted that “Plaintiffs have not overcome Defendants’ argument that Facebook reasonably believed that the data had been deleted and thus that there was no risk of improper access”. (Second Dismissal at 42, footnote 5)

Accordingly, in the Second Dismissal the District Court held that Amalgamated Bank had failed to plead falsity as required by the PSLRA for the risk factors and granted the Facebook’s motion to dismiss as to those statements, with leave to amend. It should be kept in mind that the Second Dismissal was entered before the decision of the Ninth Circuit in *Alphabet* on June 16, 2021.

Amalgamated Bank filed the Third Amended Complaint (the “TAC”) on October 16, 2020. The District Court found that the TAC alleged no additional facts curing the defects in the SAC that it had pointed out in the Second Dismissal – particularly facts demonstrating that the Defendants knew that Cambridge Analytica had not deleted, and was improperly using, the misappropriated data. The District Court dismissed the TAC in its entirety on December 20, 2021, this time without leave to amend. This dismissal was entered after the Ninth Circuit’s decision in *Alphabet*.

C. Ninth Circuit

Amalgamated Bank appealed the decision of the District Court to the Ninth Circuit, arguing primarily that "[r]isk disclosures that speak entirely of as-yet unrealized risks and contingencies and do not alert the reader that some of these risks may already have come to fruition can mislead reasonable investors". (Brief of Plaintiffs-Appellants at 29, citing *Alphabet* at 703). More precisely, Amalgamated Bank argued that the District Court misconstrued the law when it held that a risk statement could not be false unless the adverse effect on Facebook's business had already materialized when the statement was made. (Brief of Plaintiffs-Appellants at 30)

Facebook appeared to accept the proposition that if a particular risk has materialized, disclosure of that risk as purely hypothetical can, depending upon the circumstances, be misleading. Consistent with the holding of the District Court in the Second Dismissal, however, Facebook argued that, while a misappropriation of user data had occurred, *the risk warned of* – i.e. harm to the company – had not materialized. (Appellees' Answering Brief at 14 and 25, citing *Alphabet* and *Williams*)

The Ninth Circuit, prior to briefly summarizing the factual background, noted, perhaps with a touch of humor:

> The Third Amended Complaint clocked in at 285 pages. Although impressive in terms of magnitude, we nonetheless examine the allegations individually and holistically, not by weight or volume. (*Facebook*, 87 F.4th at 941)

The court then re-analyzed the risk statements in the context of its decision in *Alphabet*, ultimately reversing the District Court as to those statements, holding, among other things that:

> The inadequacy of the risk statements, however, is not that Facebook did not disclose Cambridge Analytica's breach of its security practices. Instead, the problem is that Facebook represented the risk of improper access to or disclosure of Facebook user data as purely hypothetical when that exact risk had already transpired. A reasonable investor reading the 10-K would have understood the risk of a third party accessing and utilizing Facebook user data improperly to be merely conjectural. (*Id.* at 949)

The dissent from the Ninth Circuit's decision attempted to distinguish *Alphabet* on the grounds that, at the time the risk statements were confirmed in Alphabet's 10-Qs, Alphabet knew, as shown by the Privacy Bug Memo, that its previously existing security issues would trigger an immediate regulatory response and government investigation once the situation became public knowledge. On the other hand, the plaintiffs in *Facebook* did not allege that Facebook knew that its security breaches "would lead to immediate harm to its business or reputation".

The majority, commenting on the dissent, held that:

> The dissent's suggestion that the shareholders have not adequately pleaded falsity because they "have not sufficiently alleged that Facebook knew that its reputation and business were already harmed at the time of the filing of the 10-K" fares no better. Our case law does not require harm to have materialized for a statement to be materially misleading. Facebook's statement was plausibly materially misleading even if

> Facebook did not yet know the extent of the reputational harm it would suffer as a result of the breach: Because Facebook presented the prospect of a breach as purely hypothetical when it had already occurred, such a statement could be misleading even if the magnitude of the ensuing harm was still unknown. Put differently, a company may make a materially misleading statement when it "speaks entirely of as-yet-unrealized risks" when the risks have "already come to fruition." *Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 987 (9th Cir. 2008); *see also In re Alphabet*, 1 F.4th at 702-05 (holding that risk statements in Alphabet's SEC filings were materially misleading even where Alphabet's identified harm of damage to its "business, financial condition, results of operations," and more had not yet materialized at the time of the filings). The mere fact that Facebook did not know whether its reputation was already harmed when filing the 10-K does not avoid the reality that it "create[d] an impression of a state of affairs that differ[ed] in a material way from the one that actually exist[ed]." (citing *Brody v. Transitional Hosps. Corp.*, 280 F.3rd 997, 1006 (9th Cir. 2002))

D. Petition for Certiorari

On March 4, 2024, Facebook filed with the Supreme Court a Petition for a Writ of Certiorari (Case No. 23-980) to review the judgment of the Ninth Circuit on the following specific question:

> Are risk disclosures false or misleading when they do not disclose that a risk has materialized in the past, even if that past event presents no known risk of ongoing or future business harm? (Petition at *i*)

Facebook also asked the Supreme Court to review an issue relating to loss causation, but that issue is beyond the scope of this note, and, in any case, the Court declined to review that issue. As will be evident from the following discussion, there was some disagreement between the petitioners and the respondents as to what the Ninth Circuit actually held. The author of this note suggests that it is not crystal clear what that court specifically held or how the specific question presented by Facebook to the Supreme Court relates to that holding.

Facebook Argument for Certiorari

A cornerstone of Facebook's argument was that the December 2015 article in *The Guardian* had no effect on Facebook's stock price. (Petition at 7). Accordingly, since the market appeared not to care, Facebook had no reason to believe that the incident was having, or was likely to have, an adverse effect on Facebook's business.

Facebook also alleged that, as a result of the Ninth Circuit's decision, there was a three-way split among eight circuit courts, describing the split, in summary, as follows:

> *Ninth Circuit*: risk disclosures must include past instances when risks came to fruition even if the company has no basis to believe those events will harm the business. (Petition at 18)
>
> *Sixth Circuit*: companies need not disclose [in the risk factors discussion] past events because "[r]isk disclosures like the ones accompanying 10-Qs and other SEC filings are inherently prospective in nature". (Citation omitted) (Petition at 18-19)

First, Second, Third, Fifth, Tenth and D.C. Circuits: risk disclosures should disclose the past materialization of a risk when the company is already experiencing, or will inevitably experience, adverse effects on its business. (Petition at 19-21)[2]

Amalgamated Bank's Argument against Certiorari

The thrust of Amalgamated Bank's Argument in its Brief in Opposition, dated April 29, 2024, was that Facebook was mischaracterizing a basic fact – the content of the December 2015 article in *The Guardian*. According to Facebook, this article disclosed the misappropriation, there was no reaction in the market, and, accordingly, Facebook had no reason to expect an adverse effect on the Company. Amalgamated Bank, however, pointed out that the Ninth Circuit had a different view of the import of the article in *The Guardian*:

> The [Ninth Circuit] acknowledged Facebook's argument, embraced by the dissent, that the Company reasonably believed no harm of *any* magnitude was forthcoming because the misappropriation had been fully disclosed to the public in the original 2015 article[s] and the public had failed to react. (Citation omitted). The court did not dispute that if that were true, there would be no liability. (Citation omitted). But rejecting Facebook's view of the facts, the court found that "the extent of Cambridge Analytica's misconduct was *not* yet public when Facebook filed its 2016 10-K. (Citation omitted). While the 2015 article included allegations of misconduct, those allegations were denied by those directly involved and Facebook simply said it would look into the matter and take "swift action" if it found wrong-doing, something it never publicly did until years after its misleading SEC filings. (Brief in Opposition at 8-9, referring to *Facebook*, 87 F.4th 943 at 950)

The conclusion of Amalgamated Bank's argument was that since the 2015 *Guardian* article did not fully disclose the problem, the "truth-on-the-market" defense[3] did not apply and it was not reasonable for Facebook to conclude that there was no known risk of business harm from the past events. Thus, the Ninth Circuit had effectively held that the factual basis of Facebook's defense was false.[4] In sum, Amalgamated Bank argued:

> By entertaining Facebook's argument, the Ninth Circuit made clear that it was *not* holding that companies have a duty to disclose past events that "present no known risk of ongoing or future business harm". (Petition at *i*). Instead, it held that a company cannot treat an adverse event as a hypothetical risk when the risk *is* material and has already been materialized. (Brief in Opposition at 13-14)

Amalgamated Bank further argued that there is no split among the circuits (even the Sixth Circuit), stating among other things, that:

> Each of the circuits Facebook cites recognizes that it is misleading for a company to portray a *material* risk to its business as a merely hypothetical prospect when the risk (a) has already materialized, or (b) has not yet materialized but is virtually certain to occur. (Brief in Opposition at 14, citations omitted, emphasis added)

Amalgamated Bank observed the definition of the term "material", as set forth in *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976) ("*Northway*") and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) ("*Basic*") and adopted by the SEC in its regulations under the 1933 and 1934 Acts[5], and commented:

> Investors may reasonably think that adverse events are material when they pose a real *risk* to the company's bottom line, even if the extent of that harm is not entirely clear or has not yet been inflicted. (Brief in Opposition at 22)

Facebook's Argument in Reply

In its Reply Brief, dated May 13, 2024, Facebook reiterated its interpretation of the Ninth Circuit's decision that "risk disclosures are misleading if they fail to chronicle past mistakes when a risk came to fruition – even if those past events pose no known risk of business harm" and, accordingly, further repeated its position that the decision was an outlier in the law in the various circuits. In support of its argument, Facebook quoted the following excerpts from the Ninth Circuit's decision:

> "Our case law does not require harm to have materialized for a statement to be materially misleading," and it was "the fact of the breach itself, rather than the anticipation of reputational or financial harm, that caused anticipatory statements to be materially misleading." (Reply Brief at 2)

Facebook noted the Supreme Court's recent decision, issued April 12, 2024, in *Macquarie Infrastructure Corp. v. Moab Partners, L.P.*, 601 U.S. 257 (2024) ("*Macquarie*"), which held that only "half-truths", not "pure omissions", are actionable under Rule 10b-5(b). Facebook suggested that Amalgamated Bank was attempting to recast the failure to disclose that past event as an omission that rendered the risk factor a misleading "half-truth" rather than a "pure omission" in and of itself, since, under *Macquarie*, a "pure omission" is not actionable under Rule 10b-5(b).[6]

Amici Curiae

Various other parties filed briefs as *amici curiae*, including particularly, but without limitation, the Chamber of Commerce of the United States of America and the Securities Industry and Financial Markets Association, which filed jointly. The latter *amici* made robust arguments supporting Facebook, to a great extent reiterating, and perhaps refining, Facebook's arguments.

Certiorari Granted

On June 10, 2024, the Supreme Court granted Certiorari on the first question presented by Facebook, namely:

> Are risk disclosures false or misleading when they do not disclose that a risk has materialized in the past, even if that past event presents no known risk of ongoing or future business harm.

Brief for Petitioners

Facebook filed its Brief for the Petitioners on August 9, 2024. Facebook refined many of its previous arguments, emphasizing forcefully that the purpose of Item 105 of the SEC's

Regulation S-K is to require disclosure of risks of harm that could occur in the future, not historical information:

> With respect to ordinary risk disclosures under Item 105, a reasonable investor would understand them to be forward-looking and probabilistic in nature. Item 105 requires the disclosure of "risk" − the possibility, but not certainty, of a loss. Risk disclosures thus inherently refer to harms that *could* materialize in the future. Risk disclosures usually warn of a risk of harm that "could" or "may" occur from some triggering event − language indicating the speaker is conveying only that there is some possibility of the risk occurring in the future.
>
> A reasonable investor would not interpret such forward-looking, probabilistic statements as implicitly certifying that the triggering event identified had never occurred in the past and that the company faced no present risk of harm from such an occurrence. That is especially true when, in contrast to Item 105, other items in Regulation S-K expressly require the disclosure of information about previous or ongoing events.

(Brief for Petitioners at 15)

Facebook also argued that the Ninth Circuit's decision was inconsistent with the Supreme Court's subsequent decision in *Macquarie* since the proposition that "forward-looking 'could' or 'may' disclosures silently imply the absence of any previous incidents concerning the risk … turns every pure omission of historical fact into a hook to argue that the omission create[d] an impression of a state of affairs that differ[ed] in a material way from the one that actually exist[ed]. (Brief for the Petitioners at 31, referring to *Facebook*, 87 F. 4th at 948). The Ninth Circuit essentially ignored the distinction made in *Macquarie* between nonactionable "pure omissions" and actionable "half-truths". (*Id* at 31)[7]

Brief for Respondents

Amalgamated Bank filed its Brief for Respondents on September 24, 2024. This brief highlighted many fundamental disagreements as to law and fact, including what the Ninth Circuit actually held. After reciting the question presented, Amalgamated Bank emphatically stated:

> The answer is "no". If a past event presents no risk of ongoing or future harm to the business and, as a result, is immaterial to investors, failing to disclose that immaterial event does not make a risk disclosure misleading … Respondents have never argued otherwise, and the Ninth Circuit held nothing to the contrary … What the Ninth Circuit actually held was that publicly treating such a material adverse event [i.e. the misappropriation and misuse of data] as a merely hypothetical prospect can be misleading even if the event has not *yet* produced follow-on business harm because the company has kept the truth from the public.

(Brief for Respondents at 1)

Amalgamated Bank noted that the Ninth Circuit "recognized that the undisclosed event here – the misappropriation and misuse of over 30 million Facebook users' private data – was material because it risked harm to the company's reputation, bottom line, and stock price, as

Facebook's own risk statements had warned." (Brief for Respondents at 1). Facebook had not argued that the misappropriation and misuse of data was not material in and of itself – it argued that it was not material because it was made public by the December 2015 article in *The Guardian* (which argument did not persuade the Ninth Circuit because the article did not disclose the full extent of the misappropriation and misuse). Accordingly, materiality was not an issue in the Ninth Circuit's decision.

Amalgamated Bank further noted that Facebook had acknowledged "the judicial consensus that presenting a materialized risk as a hypothetical prospect can be misleading" (Brief for Respondents at 2) and actionable unless the risk is not material.

Amalgamated Bank also took issue with Facebook's argument that risk disclosures pursuant to Item 105 of Regulation S-K are inherently forward-looking, that other parts of an annual report on Form 10-K contain historical information (to the extent required) and that, accordingly, a reasonable investor would not expect Item 105 information to disclose historical events and would not infer from the absence of disclosure of a past event that such an event had not occurred. Rather, Amalgamated Bank recited the regulatory history of Item 105, pointing out that a previous version gave examples of specific historical events or circumstances that would require risk disclosure, and argued persuasively that the occurrence of an event that created a risk of future material harm to a company, although such harm has not yet occurred, was a "factor" required to be disclosed under Item 105. (Brief for Respondents at 29). Amalgamated Bank also provided an exhaustive listing of judicial precedents that "recognized that a statement may also be a misleading half-truth when it portrays an adverse event as a hypothetical risk even though it has already transpired or is virtually certain to do so soon." (Brief for Respondents at 14)

Brief for the United States

The United States, through the Department of Justice and the SEC, filed a brief as *amicus curiae* supporting Amalgamated Bank on October 1, 2024. The U.S. argued powerfully that, "[i]n the securities context as elsewhere, a forward-looking statement of risk can be misleading insofar as it implies that the relevant risk has not already come to fruition. The antifraud provisions of the securities laws prohibit half-truths, not just flat out lies, and there is no exception to that principle for risk factor statements." (Brief for the United States at 10)

The United States drew a parallel to the holding of the Supreme Court in *Omnicare* to the effect that a statement of opinion or belief in a disclosure document is not actionable if:

- the maker of the statement actually holds that opinion or belief; and
- to the extent that the statement implies that the maker of the statement has a reasonable basis for such opinion or belief, the maker actually has such reasonable basis.

A reasonable investor could infer from a statement of opinion or belief that the maker of the statement had a reasonable basis for such opinion or belief. Conversely, if the maker has no such reasonable basis, there could be liability based on either (x) breach of an implied representation that there was such a reasonable basis or (y) the omission to state that there was no such basis, which omission rendered misleading the statement of opinion or belief.

(*Omnicare* at 11-15)

Based on the *Omnicare* principle, the United States argued that a reasonable investor could infer from the statement of a hypothetical risk that the risk had not yet materialized, or that the stated trigger event has not yet occurred, and that the failure to disclose such materialization or such occurrence resulted in liability for a false or misleading statement, as under *Omnicare*.

The United States emphasized its view that there can be no categorical rule since liability "depends on the perspective of a reasonable investor" in the particular case (citing *Omnicare*, 575 U.S. at 186-187). The United States summed up its views thus:

> In the securities context, whether a given statement about the likely consequences of potential future events is a material misrepresentation depends on whether a reasonable investor (a) would construe the statement as an implicit representation that such events have not already occurred, and (b) would view the undisclosed occurrence as significant to an appraisal of the company's business prospects. Those are "inherently fact-specific," context-dependent inquiries. *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988). In at least some circumstances, however, it is plainly misleading to characterize an adverse event that has already materialized as a merely hypothetical future risk.

(Brief for United States at 14-15)

The United States noted that some courts (which include the United States Court of Appeals for the Second Circuit) have held that "risk factor statements are misleading only if they omit 'previous occurrences of the triggering event' that the company knows "are almost certain to cause the warned of harm to the company's business" (citation omitted) and urged the Supreme Court to reject this "virtual certainty" rule explaining that:

> Among other things, that rule would artificially raise the bar in the risk-factor context for establishing the element of materiality, which does not require that a misrepresentation involve near-certain harm to the issuer's business.

(Brief for United States at 11)

Brief for Law Professors and Former Officials of the SEC, as Amici Curiae

The brief of these *amici,* filed in support of Facebook, is interesting for two reasons. First, these *amici* seemed to have assumed, without investigation (certainly without substantive discussion), the accuracy of the hypothesis stated in Facebook's question to the Supreme Court – "even if that past event presents no known risk of ongoing or future business harm" – a notion that the Ninth Circuit apparently did not accept. See note (4) *supra*.

In addition, these *amici* bemoaned the steady expansion of risk factor discussions, commenting that "[o]ver time, concerns emerged that disclosures were becoming longer and more detailed yet less effective", and quoting a study performed in 2019 that "found that registrants increased the length of risk factor disclosures from 2006 to 2014 by more than 50 percent in terms of word count *** and that this increase in risk factor word count may not be associated with better disclosure." The *amici* further noted suggestions that "attributed the growing length of risk factor disclosure to the fear of litigation for failing to disclose risks that later materialized." (Brief at 4). The *amici* concluded with a robust discussion of the evils of information overload. (Brief at 7-10)

E. Oral Argument

The Supreme Court entertained oral argument by the parties and the *amici* on November 6, 2024. This note will mention only a few salient points made by the parties and inquiries raised by the Justices. (See note (8) for a link to the transcript of the oral argument.)[8]

Facebook

Facebook's primary argument was that a risk factor ordinarily does not contain any implied representation that the trigger event has not occurred in the past:

> But just as a statement that the road may be flooded if it rains cannot be misleading simply because it rained yesterday, a typical risk disclosure cannot be misleading simply because the triggering event had occurred in the past. (Transcript at 4)

Facebook did concede, however, that depending on the content of the statement and the context in which it is made, a forward-looking risk disclosure can be misleading based on such an implied representation. Justice Kagan clearly agreed with that premise. (Transcript at 4-12).

Facebook thus seemed to depart from the proposition it advanced earlier in the litigation that a forward-looking risk factor categorically can never be misleading as to historical information. Instead, it argued that it was Amalgamated Bank and the United States that were advancing the argument that the decision of the Ninth Circuit set forth a categorical rule that a risk factor is always misleading if it does not disclose previous occurrences of the trigger event, "subject only to the caveat that it has to be material". (Note that this caveat appears to depart from the specific question on which certiorari was granted, as was pointed out emphatically by Justice Sotomayor.) (Transcript at 24). Facebook supplemented this basic argument by noting that "… in any event, the initial misuse of the data had been publicly reported by the time Meta made the statements at issue" and "…did not result in any harm when it was publicly reported", and thus was not material. (Transcript at 5)[9]

Extensive questions were asked by the Justices, many pointing out the concern that the non-disclosure of the occurrence of a trigger event in the past can, in some circumstances, be misleading. Justice Jackson remained concerned that, without disclosure of the occurrence of the trigger event, the investor would miscalculate the probability of the ultimate harm:

> [w]hen you say your statement totally futuristically, as though that has – the burglaries [trigger event] never happened, they're miscalculating. They're being misled into making that calculation. (Transcript at 14)
>
> [y]ou've misled him [the investor] into thinking that he has to wait for a future triggering event as opposed to he has to do what he needs to to mitigate the harm that will already happen as a result of the past triggering event. (Transcript at 49)

Facebook's consistent response to Justice Jackson, and the essence of its argument, was:

> I think we would draw a link between a circumstance in which the harm has currently materialized, in other words, the harm is on-going and, therefore

> will exist in the future, and a circumstance in which there is simply a present risk of harm, whether from a past event or a future event.
>
> I think, if there is merely a risk, there would be no liability because that risk is precisely what you're warning of, and you're not making any warranty about whether the triggering event has occurred in the past.

(Transcript at 49-50)

Justices Kavanaugh and Gorsuch both inquired whether disclosure of the occurrence of a trigger event could be required elsewhere in a Form 10-K, such as Items 101 and 303 and, where appropriate, newly adopted Item 106. The positive response by Facebook seemed to reinforce Facebook's argument that Item 105 is written to address only future risks, not past events. It was acknowledged that, in any case, only Item 105 disclosure was at issue in this case. (Transcript at 17-18, 26-27, 41)

Justice Alito indicated his belief that "a statement that simply blandly says that there's a possibility of a risk can, in context, be extremely misleading if there is a high probability of the risk materializing". (Transcript at 30). Similarly, Justice Gorsuch seemed to express his belief that "an if/then statement can be misleading and materially possibly so if it understates the risk going forward, the probability of it." (Transcript at 37). Facebook did not entirely agree with either of these propositions for a number of reasons including that Item 105 does not require, and companies do not generally make, any warranty about the probability of any risk actually occurring. (Transcript at 39-40)

Amalgamated Bank

Amalgamated Bank first clarified its position, summarized as follows:

- it agreed with Facebook that a risk disclosure is not misleading by the omission of a historical trigger event that is not material because it poses no risk of harm, pointing out that the Ninth Circuit did not hold otherwise (illustrating the flaw in Facebook's question on which *certiorari* was granted);

- depending on the facts and context, risk statements can, and frequently do, imply that the trigger has not occurred; and

- more particularly, stating a risk in purely hypothetical terms implies that there is a possibility that the risk will not materialize; but this is false if the risk has already materialized when the statement is made.

(Transcript at 51-52)

After questioning by Chief Justice Roberts and Justice Gorsuch, those Justices and Amalgamated Bank seemed to be in agreement that there can be an implied representation that a triggering event has not occurred in the past, especially in cases in which such event is not such that it happens, or can be expected to happen, all the time. A distinction was drawn between a data breach, which happens all the time, and the facts in this case in which Facebook provided the data on its own accord, which does not happen all the time. (Transcript at 60-61)

There was further discussion of the notion that sometimes there is an implied representation and sometimes there is not. Justice Kavanaugh suggested that it might be more appropriate for the SEC to figure out the appropriate dividing line and impose it by regulation. A distinction was again made between a discrete triggering event that has occurred in the past and may well occur again in the future, on the one hand, and a triggering event that occurred in the past and is going to have an effect in the future, on the other. (Transcript at 65-66). There was discussion about which of those two situations was involved in the present case and general agreement that it was the second. (Transcript at 65-66). Justice Jackson observed that the specific question on which certiorari had been granted did not really capture the second situation because, contrary to the Ninth Circuit's finding, Facebook's question assumed that the occurrence of the trigger would cause no harm to the Company. (Transcript at 80)

United States

The United States, acting through the Department of Justice and the SEC, as *amicus curiae*, offered its argument in support of Amalgamated Bank, making two basic points:

- Facebook's proposed categorical rule that a risk factor is solely forward-looking and can never be taken to make any representation about the past is flawed; and Facebook now appears to acknowledge that a risk factor can make an implicit representation about the past; and

- the question presented by Facebook, on which the Court granted certiorari, does not accurately capture the decision of the Ninth Circuit – "[g]iven the obvious importance of the Cambridge Analytica matter to Facebook's business, which depended so heavily on user data, the court of appeals had no occasion to hold that nondisclosure of an unimportant event renders a risk statement misleading." (Transcript at 82)

Accordingly, the United States argued that "Facebook should have said at least that they had experienced a significant episode of misappropriation of user data". (Transcript at 82)

After much discussion, the question of whether the SEC should clarify Item 105 came up, and Justice Kavanaugh suggested a simple solution:

> When the company discloses the risk of a future event that could cause harm, also disclose any past occurrences of the event. (Transcript at 99)

There followed discussion of the obvious problems with such a formulation – over disclosure of immaterial past events, on the one hand, and a disincentive to give meaningful detailed information, on the other. This discussion concluded with the recognition that the current regulatory scheme already requires disclosure of whatever is necessary to avoid statements made being misleading and that, as acknowledged in *Omnicare,* "[w]henever you have a provision that prohibits half-truths, not just outright lies, you're going to have uncertainty and it's not going to be completely cut and dry." (Transcript at 101-102)

Justice Jackson observed, with respect to a statement made after the occurrence of a trigger event but before the harm completely materializes, that "… maybe there's something misleading about making your statement purely futuristically in that situation because it leads investors to underestimate the risk or the potential for the future harm." (Transcript at 106)

The United States emphasized its interpretation that Item 105 "requires disclosure of [ ] material factors that render an investment in the company risky or speculative, and that can readily encompass past events, present conditions, and potential future events". (Transcript at 107)

F. Dismissal of Writ

On November 22, 2024, the Supreme Court dismissed the writ of *certiorari*, stating only that it had been "improvidently granted".

IV. Observations

A. Fundamental Requirement of Item 105

The fundamental requirement of Item 105 is:

> *Where appropriate*, provide under the caption "Risk Factors" a discussion of the *material* factors that make an investment in the registrant or offering *speculative* or *risky*. (emphasis added)

The requirement to disclose is clearly subject to several qualifications. First disclosure is only required if the investment in the registrant or the offering is "speculative" or "risky". Examination of the definition of these terms is necessary, "speculative" being derived from the verb "speculate" and "risky" being derived from the noun "risk":

- <u>Speculate</u>. In *Oxford Languages*, Oxford University Press, "speculate" is defined as, among other things, to "form a theory about a subject without firm evidence" or to "invest in stocks, property, or other ventures in the hope of gain but with the risk of loss". "Speculative" is then defined as "engaged in, expressing, or based on conjecture rather than knowledge" or "(of an investment) involving a high risk of loss".

  In the *Cambridge Business English Dictionary*, Cambridge University Press, "speculate" is defined as, among other things, "to guess possible answers to a question when you do not have enough information to be certain" or "to buy something hoping that its value will increase and then sell at this higher price in order to make a profit". "Speculative" is then defined as "based on a guess and not information" or "done in order to make a profit even though there is risk that you may lose money".

- <u>Risk</u>. In *Oxford Languages*, Oxford University Press, "risk" is defined as, among other things, "a situation involving exposure to danger", "the possibility that something unpleasant or unwelcome will happen" or "the possibility of financial loss". "Risky" is then defined as, among other things, "full of the possibility of danger, failure, or loss" or "dangerous", "hazardous", "unsafe" or the like.

  In the *Cambridge Business English Dictionary*, Cambridge University Press, "risk" is defined as, among other things, "the possibility that something bad or dangerous will happen", "the possibility that something will be harmed, damaged or lost" or "the possibility that an investment will lose money". "Risky" is then defined as, among other things, "involving the possibility that something bad might happen or that something will fail or lose money" or, as to a business, "that may not be safe to lend money to" or "that involves risk or the chance of failure".

If an investment in the registrant or the offering is not "speculative" or "risky", no disclosure is technically required by Item 105. Reinforcing this notion is the phrase "where appropriate" that introduces the fundamental requirement of Item 105. Furthermore, assuming that an investment is "speculative" or "risky", only the "material" factors that cause the investment to be so are required to be discussed. This is reinforced by the language in Item 105 (a) specifically discouraging the presentation of "risks that could apply generically to any registrant or any offering" and requiring those risk factors, if presented, to be disclosed at the end of the risk factor section under the caption "General Risk Factors". Indeed, in its release adopting changes in Item 105 to its current form, the SEC emphasized that "[w]e believe that the final amendment will result in risk factor disclosure that is more tailored to the particular facts and circumstances of each registrant, which should reduce the disclosure of generic risk factors…" (Release Nos. 33-10825; 34-89670 (effective November 2020)).[10] If the SEC had intended to require a discussion of all risk factors with respect to all registrants and all offerings, it certainly could have done so but clearly did not.

Notwithstanding these qualifications and distinctions, market practice appears to have evolved to the point at which substantially all registrants set forth risk factors even where the proposed investment would not generally be regarded as "speculative" or "risky" and include a litany of generic risk factors. Given the prevalence of this market practice, no suggestion is being made that registrants should swim against the tide and follow the rule literally, perhaps not discussing risk factors at all. However, the foregoing should be kept in mind when assessing whether or not a particular risk merits discussion.

B. Half-Truths vs. Pure Omissions

Both *Alphabet* and *Facebook* were brought under Section 10(b) of the 1934 Act and Rule 10b-5(b) thereunder. As such the plaintiffs had to show that a statement made in the disclosure document was either untrue or misleading by omission. The plaintiffs did not have the luxury of claiming, as under Section 11(a) of the 1933 Act, that the disclosure document "omitted to state a material fact *required* to be stated therein" (emphasis added), that is, alleging a "pure omission" of required information. As was discussed in oral argument, the misuse of user information by Cambridge Analytica could well have been required under Item 101 (Description of Business) and/or Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations) of Regulation S-K (or, effective September 5, 2023, under Item 106 (Cybersecurity)), and, in an action under Section 11(a), Alphabet and Facebook could have had liability for failure to disclose such information as required. However, in *Alphabet* and *Facebook,* the plaintiffs were limited to making claims under Rule 10b-5(b) that:

- the risk factor statement itself was rendered misleading by the omission of disclosure that the trigger event had occurred; and/or

- the risk factor disclosure contained an implied representation (as under *Omnicare*) that the trigger event had not occurred, and that this implied representation was untrue.

If 1934 Act reports will be incorporated by reference into a registration statement filed under the 1933 Act, companies should keep in mind that Section 11(a) of the 1933 Act will be available to plaintiffs who claim that the occurrence of a trigger event was required to be disclosed elsewhere in a Form 10-K, such as under Item 101, 303 or, where appropriate, 106.[11]

C. Conditional Risks

Many risk factors are in substance the combination of two risks – the risk of a trigger event occurring and the risk of the ultimate event or effect (usually harm of some kind to the company) occurring as a result of the prior occurrence of the trigger event. This is true even if the disclosure is styled otherwise. For example, a statement that "the loss of a major customer could adversely affect our revenues and earnings" is substantively the same as "if we were to lose one of our major customers, our revenues and earnings could be adversely affected." Likewise, a statement that "extended periods of hot, dry weather could increase the likelihood and intensity of wildfires" is substantively the same as "if the Company experiences an extended period of hot, dry weather, this could increase the likelihood and intensity of wildfires." The prospective investor then, in evaluating the investment, has to take into account both risks, and the probability of the ultimate event or effect occurring is mathematically the product of the probability of the trigger event occurring multiplied by the probability of the ultimate event or effect occurring (assuming that the trigger event has occurred).[12] As was observed by Justice Jackson in the oral argument (Transcript at 106), if the trigger event has already occurred, the probability of the occurrence of the ultimate event or effect is increased but, without disclosure that the trigger event has occurred, the investor cannot accurately assess the probability of the occurrence of the ultimate event or effect.[13]

D. Disclosure of Trigger Event

Whether disclosure of the occurrence of a trigger event is necessary depends on the circumstances. Not all trigger events have to be disclosed. As argued by Facebook, and noted above:

> … a statement that the road may be flooded if it rains cannot be misleading simply because it rained yesterday… (Transcript at 4)

It would seem that disclosure of a particular trigger event may not be necessary if that event is something that, in fact, occurs regularly and would be expected by a reasonable investor to do so. That said, there likely are circumstances in which the disclosure of the recurring nature of this type of trigger event may be advisable.

On the other hand, if a particular trigger event is not something that, in fact, occurs regularly, or, even if it does, is not something that a reasonable investor would expect to occur regularly, perhaps the occurrence of the trigger event should be disclosed.

Finally, the degree of probability that a trigger event will result in the ultimate event or effect – some kind of harm to the company – must be considered. Facebook argued throughout the litigation that the law in some circuits required disclosure of a trigger event when the ultimate effect or event had already started to occur or was "virtually certain" to do so. However, the United States argued that the question should be governed by general principles of materiality – that is, the proper question is whether "a reasonable person [would] view the information as significantly altering the total mix of information bearing on the investment decision." (Brief at 11, Transcript at 103, 104). In the view of the author of this note, Item 105 clearly requires disclosure of "risks", not "virtual certainties", and, in the absence of further guidance under Item 105 on the disclosure of the occurrence of trigger events, perhaps the probability/magnitude test set forth in *Basic* 485 U.S. at 238 should be looked to for guidance:

> Even before this Court's decision in *TSC Industries* [*Northway*], the Second Circuit had explained the role of the materiality requirement of Rule l0b-5, with respect to contingent or speculative information or events, in a manner that gave that term meaning that is independent of the other provisions of the Rule. Under such circumstances, 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." (Citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968))

The probability/magnitude test for materiality, however, could result in the disclosure of risks "that are large in potential magnitude but low in probability", such as the risk of being hit by a meteorite. In Release Nos. 33-10890; 34-90459 (at 46-49), the SEC explained that it sought to avoid the disclosure of low probability uncertainties in Item 303 by setting a "reasonably likely" probability threshold. There might be some logic to applying that threshold to Item 105 disclosures, but in a section dedicated to the disclosure of risk, perhaps the "reasonably possible" standard of Item 305 would be more appropriate. Guidance from the SEC would be welcome.

E. Primary Location of Disclosure of Trigger

The information required by the disclosure framework of Regulation S-K is quite comprehensive, although some bits of information might, in theory, slip through the cracks and arguably not be required by any specific Item of the regulation. In the view of the author of this note, information should ordinarily be provided under the Item that calls for it. In particular, Item 105 should focus on risks and not on historical information. To the extent that the occurrence of a trigger event relates to information called for under another Item of Regulation S-K, the primary discussion of that occurrence should be under that Item and not under Item 105.[14] However, as was observed by the Justices, it is difficult to draw any categorical bright lines since possible fact situations, as well as drafting options, are limitless, and in some cases disclosure of past events in the risk factor itself, at least to some degree, may be necessary or advisable, either directly or at least by cross-reference.

F. Conclusion

As is the case with many questions arising under the federal securities laws, there are no hard and fast rules as to whether, when, what and where to disclose the materialization of a risk or the occurrence of a trigger event. These questions must ultimately be resolved by the considered judgement of those involved in making disclosure decisions, keeping in mind what the securities laws require, explicitly and implicitly, and, of course, the immutability of liability being determined only in hindsight.

ENDNOTES

[1] In October 2021, Facebook, Inc., the parent company of Facebook, changed its name to Meta Platforms, Inc. However, the defendant is referred to as "Facebook" throughout the litigation.

[2] This note will not analyze the law in the various federal circuits or comment on Facebook's analysis, except to note Facebook's discussion of the law in the Second Circuit, citing *Set Capital LLC v. Credit Suisse Grp. AG*, 996 F.3d 64 (2d Cir. 2021), wherein the court held:

> As we explained in *Wilson v. Merrill Lynch & Co., Inc.*, [671 F.3d 120, 130 (2d Cir. 2011)] "the law is well settled that so-called 'half-truths' – literally true statements that create a materially misleading impression – will support claims for securities fraud." In a similar vein, cautionary words about future risk cannot insulate from liability an issuer's failure to disclose that the risk has, in fact, materialized in the past and is virtually certain to materialize again. As the D.C. Circuit explained in *Dolphin & Bradbury, Inc. v. SEC*, [512 F.3d 634, 640 (D.C. Cir. 2008)], there is a "critical distinction between disclosing the risk a future event *might* occur and disclosing actual knowledge that the event *will* occur" – particularly where that distinction holds "enormous significance" for investors.

(996 F.3d at 85. See also Note (6), *infra.)*

[3] Discussion of the "truth-on-the market defense" is beyond the scope of this note. In short, under the efficient market hypothesis, corrective information may be a defense to a claim of securities fraud by rendering the alleged untrue statement or omission no longer material. In addition, a showing that corrective information had no price impact has also in some courts deprived plaintiffs of the fraud-on-the-market presumption of reliance. See *Arkansas Teachers Retirement System v. Goldman Sachs Group, Inc.*, 879 F.3d 474 (2d Cir. 2018); and Lucy Chang, *The Truth-On-The Market Defense and It's Relevance in SEC Enforcement Actions,* 76 Law and Contemporary Problems 341 (2014), available at https://scholarship.law.duke.edu/lcp/vol76/iss3/11.

[4] The difference between Facebook's view of the facts and that of the Ninth Circuit is crucial to an understanding of this litigation in the various courts. Facebook repeatedly argued that the Cambridge Analytica problem was sufficiently disclosed in the 2015 article in *The Guardian* and the 2016 article in *The Washington Post*, that they had no effect on the market price of Facebook stock and that, accordingly, no harm to Facebook could have reasonably been expected at that time (and that the Cambridge Analytica problem was therefore not "material"). The Ninth Circuit had a different view of the facts, particularly the sufficiency of the articles in *The Guardian* and *The Washington Post* to warn investors:

> Notably, although the dissent seemingly perceives it otherwise, the extent of Cambridge Analytica's misconduct was not yet public when Facebook filed its 2016 10-K. Although the articles may have raised concerns about Cambridge Analytica's conduct, Facebook did not confirm before the 2016 10-K was filed that Cambridge Analytica had acted improperly or whether Facebook had taken the "swift action" promised if it learned of violations. At the time the 10-K was filed in February 2017, the news of Cambridge Analytica's misconduct was far from "transmitted to the public with a degree of intensity and credibility sufficient to

effectively counterbalance any misleading impression." (citing *Provenz v. Miller*, 102 F.3d 1478, 1493 (9th Cir. 1996)).

(*Facebook*, 87 F.4th at 950.)

While the Supreme Court was not on a fact-finding mission, it is noteworthy that Justices Kagan, Barrett and Jackson all seemed to accept the significance ("extraordinary", "unusual") of Facebook's having released personal data of substantially all its users and its knowledge that such data had been misappropriated and misused at the time it filed the Facebook 10-K. (Transcript at 34-35, 60-61, 80-81).

5 The seminal U.S. Supreme Court case articulating a standard of materiality is *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) ("*Northway*") which was an action for damages brought under Section 14(a) of the 1934 Act and Rule 14a-9 thereunder. The Supreme Court held, among other things, that

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, 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.

(*Northway*, 426 U.S. at 449.)

In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) ("*Basic*"), the Supreme Court expressly adopted the *Northway* standard of materiality in the context of Section 10(b) of the 1934 Act and Rule 10b-5. The SEC has followed *Northway* by setting forth a definition of materiality in Rule 12b-2 under the 1934 Act, as follows:

The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.

The definition of "material" in Rule 405 under the 1933 Act is identical in relevant part.

See *Materiality in Review – Probability, Magnitude and the Reasonable Investor*, by J. Anthony Terrell (February 12, 2021).

6 See *"Half-Truths" and "Pure Omissions" – S-K Item 303 and Rule 10b-5 – The Supreme Court Spoke – Questions Remain*, by J. Anthony Terrell (July 1, 2024).

7 In *Macquarie*, the Supreme Court essentially over-turned the law in the Second Circuit, as embodied in *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015) ("*Stratte-McClure*"), which to some extent comingled the "half-truth" and "pure omission" concepts:

> A plaintiff must then allege that the omitted information was material under Basic's probability/magnitude test, because 10b-5 only makes unlawful an omission of "material information" that is "necessary to make statements made," *in this case the Form 10-Qs*, "not misleading". (emphasis added) (*Id.* at 103)

This language suggests that the Second Circuit, in *Stratte-McClure*, was looking at the entire Form 10-Q as the relevant "statements made". To that extent, *Stratte-McClure* was arguably a "pure omission" case as well as a "half-truth" case. In any event, this proposition seems to have been rejected by the Supreme Court in *Macquarie*.

See Note 6, supra.

[8] The transcript of the argument before the Supreme Court in *Facebook* is available *here*.

[9] See Notes 4 and 5, *supra*.

[10] The notion that risk factors should be specific and not general boilerplate mirrors the proposition that "meaningful cautionary statements" that accompany "forward-looking statements" (each term within the meaning of Section 21E of the 1934 Act) must be specific and not general boilerplate in order to be "meaningful" and therefore entitle the issuer to the safe harbor provided by Section 21E(c) of the 1934 Act, and further mirrors the same principles in the judicially developed "bespeaks caution" doctrine.

See Fine, *A Cautionary Look at a Cautionary Doctrine*, 10 Brooklyn Journal of Corporate, Financial and Commercial Law (2016) and the articles and cases cited therein.

[11] See *Section 11 in Review: A Reminder to Directors and Officers*, by J. Anthony Terrell (September 1, 2023).

[12] See *Materiality in Review – Probability, Magnitude and the Reasonable Investor*, *supra*, note 3 at 25.

[13] See also *Meyer v. JinkoSolar Holdings Co.*, 761 F.3d 245, 251 (2d Cir. 2014): "A generic warning of a risk will not suffice when undisclosed facts on the ground would substantially affect a reasonable investor's calculations of probability. *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004) ('Cautionary words about future risk cannot insulate from liability the failure to disclose that the risk has transpired.')".

[14] However, the "buried facts" doctrine should be observed – disclosure should be made in a manner reasonably calculated to communicate the information to a reasonable investor – that is, it cannot be hidden from view or fragmented so that a reasonable investor might not appreciate the significance of the totality thereof. See *Materiality in Review – Probability, Magnitude and the Reasonable Investor*, supra, at Note 5, citing, among other cases, *Khon v. American Metal Climax, Inc.*, 322 F.Supp. 1331 (E.D. Pa. 1971), modified, 458 F.2d 255 (3d Cir. 1972), cert. denied, 409 U.S. 874 (1972).

This note was prepared by J. Anthony Terrell as of February 1, 2025. Mr. Terrell is Of Counsel to Bracewell LLP, resident in the New York office. However, the views expressed herein are those of Mr. Terrell only and do not necessarily reflect the views of the firm. Mr. Terrell is a member of the American-Bar Association, the New York City Bar Association and the International Bar Association and various sections and committees of each. This note does not necessarily reflect the positions of any of such bar associations, sections, or committees.

This note was prepared to keep clients and other interested parties informed of legal principles and developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

Mr. Terrell acknowledges with gratitude the assistance of Stephen C. McNamara, Esq., Associate, and Patrick M. Miller, Esq., Research Analyst, in the preparation of this note.