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‘Envy of the World’: Equity Markets and the Compelling Need for Robust Disclosure Under Regulation S-K

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Almost a century ago, the stock market crash of 1929 and the resulting crisis of investor confidence spawned today’s securities laws—specifically, the Securities Act of 1933 and the Securities Exchange Act of 1934. In the lead-up to the stock market crash of 1929, some $50 billion of new securities were floated in the United States. Half, or $25 billion worth of the securities floated during that period, proved to be worthless. In today’s terms, adjusted for inflation, investor losses exceeded half a trillion dollars. Investor confidence, and confidence in U.S. markets specifically, was at its nadir.

Today, U.S. capital markets are the largest and most liquid in the world. As of 2023, U.S. equity markets totaled over $46.2 trillion in market capitalization. U.S. markets account for approximately 41 percent of global equity and 40 percent of global fixed income. The European Union ranked a distant second at

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11.1% of global equity capitalization, followed by China (10.6%); Japan (5.4%); and Hong Kong (4%). The “Magnificent Seven,” Apple, Microsoft, Google, Amazon, Nvidia, Meta, and Tesla have combined market capital greater than any foreign stock market.

U.S. regulators, in particular the SEC, have described the U.S. equity market as the “envy of the world.” *See, e.g.*, Chair Mary Jo White, Testimony on SEC Budget, Subcommittee on Financial Services and General Government,

Committee on Appropriations, U.S. House of Representatives (May 7, 2013). They credit the primacy of the country's capital markets to robust disclosure requirements and enforcement, which in turn have buttressed investor confidence.

Courts too have historically recognized that investors' faith in the accuracy of periodic issuer statements is central to investor confidence, price formation, and the integrity of the country's securities markets. As the Supreme Court explained in *Basic v. Levenson*, if "investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike." 485 U.S. 224, 235 n.12 (1987) (citation omitted).

The specific requirements of quarterly and annual reports (Forms 10-Q and 10-K) are found in Regulation S-K, which is regularly updated by the S.E.C. One of the most important elements of these periodic statements is the required "Management's Discussion & Analysis," a narrative description that allows "the investor the opportunity to look at the company through the eyes of management." Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22427-01, 22428 (May 24, 1989).

Item 303 of Regulation S-K defines the type of qualitative information companies must disclose in the Management's Discussion & Analysis section of their periodic reports. Specifically, Item 303 requires issuers to disclose "any known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. §229.303(b)(2)(ii).

Issuers' obligation to disclose known trends, either favorable or unfavorable, fosters efficiency in the market by ensuring that known risks become priced in, and protects the securities markets from otherwise-avoidable price shocks.

Yet, on April 12, 2024, the Supreme Court diminished the critical Item 303 disclosures by immunizing non-compliance from private suit. In *Macquarie Infrastructure Corp.* v. *Moab Partners, L.P.*, the Supreme Court unanimously held that an issuer's omission of a known material trend, despite the statutory and regulatory obligation to disclose it, cannot alone support a claim for securities fraud under Section 10(b) and Rule 10b-5, the Exchange Act's most sweeping anti-fraud tools. 601 U.S. 257.

The court reasoned that only "half-truths" are actionable, whereas "pure omissions" are not. And if that supposedly bright line distinction evades the average reader, the court provided a quaint analogy: "The difference between a pure omission and a half-truth is the difference between a child not telling his parents he ate a whole cake and telling them he had dessert." *Id.* at 264.

The Supreme Court's decision does not embrace the fact that, because Item 303 requires disclosure of known trends, an omission *is* a half-truth which implies that all known trends have been disclosed (or that there are no known trends). Or, to take the court's analogy, if the gluttonous child's parent asks what dessert she ate and the child does not

respond, any parent would agree that the child's silence was an attempt to mislead. It stands to reason that the same analysis was used by sophisticated investors who trusted that issuers fully complied with their affirmative disclosure obligations.

The court's rule fails to disincentivize non-compliance with Item 303: while an incomplete disclosure of known trends can support a claim of securities fraud, leaving out all known trends is immune from private suit. *Id.* at 265-66. The Supreme Court rejected this concern, reasoning that the SEC could still enforce compliance with Item 303. *Id.*

In its *amicus* brief, however, former senior leaders of the SEC supported a private right of action for "pure omissions" to complement the SEC's enforcement efforts, particularly given the Commission's limited resources. Brief of Former SEC Officials as *Amici Curiae* in Support of Respondent at 23-25, *Macquarie*, 601 U.S. 257 (No.22-1165).

Luckily for investors in the U.S equity markets, the court's opinion is limited only to "pure omissions," which stated unequivocally that "private parties remain free to bring claims based on Item 303 violations that create misleading half-truths," including the half-truths in the *Macquarie* case. *Macquarie*, 601 U.S. at 266, 266 n.2; *see Moab Partners, L.P. v. Macquarie Infrastructure Corp.*, No. 21-2524, 2022 WL 17815767, at *4 (2d Cir. Dec. 20, 2022) ("The district court also erred in determining that plaintiff failed to plead any actionable omissions or 'half-truths.' Having chosen to speak about their base of customers, defendants had a duty to speak accurately, giving all material facts in addressing those issues to permit investors to evaluate the potential risks.")

Certainly, diligent investors and creative securities lawyers will still discover misleading half-truths from unscrupulous issuers. We expect, however, that courts will have more difficulty distinguishing half-truths from pure omissions in Item 303 disclosures than parents have with their children.

More importantly, the Supreme Court's decision creates unfortunate uncertainty, as well as externalities, in our capital markets by immunizing issuers who omit known risks entirely. This "significant loophole in the securities law for conduct that is plainly fraudulent," undermines the disclosure regime that makes U.S. equity markets the "envy of the world." Brief of the United States as *Amici Curiae* in Support of Respondent at 9, *Macquarie*, 601 U.S. 257 (No.22-1165).

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