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VIA FEDERAL EXPRESS

Catherine O'Hagan Wolf, Esquire
Clerk of Court
United States Court of Appeals for the Second Circuit
Thurgood Marshall U.S. Courthouse
40 Foley Square
New York, New York 10007

Re: *Slayton, et al. v. Am. Express Co., et al.*, No. 08-5442-cv

Dear Ms. Wolf:

The Securities and Exchange Commission submits this *amicus curiae* brief in response to the Court's October 23, 2009, letter inviting the Commission to address various issues concerning the safe harbor for certain forward-looking statements in the Private Securities Litigation Reform Act of 1995 ("PSLRA"), *see* Section 21E of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-5. A panel of this Court (Circuit Judges Newman, Calabresi, and Katzmann) heard oral argument in this appeal on October 19, 2009. [1/]

The Court's letter invited the Commission to address the proper application of the statutory safe harbor to certain statements made in the Management's Discussion and Analysis ("MD&A") section of the May 2001 Form 10-Q filed by defendant American Express Company ("Amex") regarding losses in the high-yield investments of Amex subsidiary American Express Financial Advisors ("AEFA"). On Page 20 of the May 2001 Form 10-Q, Amex made the following statement: "The high yield losses [of $182 million] reflect the continued deterioration of the high-yield portfolio and losses associated with selling certain bonds. The recognition of these losses followed the quarterly analysis of the portfolio, which reviews items such as: recent defaults on interest payments, financial data from issuers, assessments of anticipated future cash flows and the overall trends in the high-yield sector. . . . *Total losses on these investments for the remainder of 2001 are expected to be substantially lower than in the first quarter*." (A. 1616, emphasis added). Page 28 of the May 2001 Form 10-Q includes the following risk disclosure: "This report contains forward-looking statements, which are subject to risks and uncertainties. The words 'believe', 'expect', 'anticipate', 'optimistic', 'intend', 'aim', 'will', 'should' and

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1/ Judge Newman subsequently recused himself from consideration of the appeal.

similar expressions are intended to identify such forward-looking statements. Factors that could cause actual results to differ materially from these forward-looking statements include, but are not limited to, . . . *potential deterioration in the high-yield sector*, which could result in further losses in AEFA's investment portfolio . . . ." (A. 1624, emphasis added).

As explained further below, the Commission takes the following positions on the Court's questions:

I. The MD&A section of a Form 10-Q is not part of a "financial statement prepared in accordance with generally accepted accounting principles" ("GAAP") for purposes of applying the safe harbor. Section 21E(b)(2)(A). Therefore, forward-looking statements made in the MD&A section of a Form 10-Q do not fall within the statutory exclusion for forward-looking statements made in a financial statement prepared in accordance with GAAP.

II.A. A forward-looking statement need not be included in a section marked "Forward-Looking Statements" or specifically labeled as a "forward-looking statement" to be "identified as a forward-looking statement" under Section 21E(c)(1)(A)(i) of the safe harbor. Although the facts and circumstances of a particular disclosure may lead to a different conclusion, identifying forward-looking statements, as Amex did in its May 2001 Form 10-Q, by including a note at the end of Form 10-Q that states that "[t]he words 'believe', 'expect', 'anticipate', 'optimistic', 'intend', 'aim', 'will', 'should' and similar expressions are intended to identify such forward-looking statements" generally should be sufficient to identify as forward-looking a statement that uses these words.

II.B. What suffices as "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement" under Section 21E(c)(1)(A)(i) of the safe harbor depends on the facts and circumstances of each case, specifically the cautionary language and the forward-looking statement it is intended to address. Here, Amex claims that any misleading impact in its forward-looking statement that "[t]otal losses on [AEFA's high-yield] investments for the remainder of 2001 are expected to be substantially lower than in the first quarter," is mitigated by the cautionary language stating that "potential deterioration in the high-yield sector . . . could result in further losses in AEFA's investment portfolio . . . ." This cautionary language was not "meaningful" under the safe harbor since, according to plaintiffs' allegations, which must be taken as true on a motion to dismiss, at the time that defendants were warning of *potential* deterioration in the high yield sector, they were aware that such deterioration was *actually occurring*. It is misleading and therefore insufficient for a company to warn of a *potentiality* that it is aware currently exists.

III. Under Section 21E(c)(1)(B)(i) of the safe harbor, a person has "actual knowledge" that a statement of projection or expectation is misleading if the person knows that he or she has no reasonable basis upon which to make the statement. Under this provision, a finding of "actual knowledge" requires more than recklessness or a reckless disregard for a substantial risk that a forward-looking statement is false or misleading. A statement of prediction or expectation, like Amex's statement that "losses . . . *are expected* to be substantially lower," contains at least three implicit factual assertions, including (i) that the statement is genuinely believed; (ii) that there is a reasonable basis for that belief; and (iii) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. If the speaker actually knows that any of the implicit representations is false, then the speaker knows that the statement is misleading.

BACKGROUND

A. The PSLRA and Safe Harbor for Certain Forward-Looking Statements

Congress passed the PSLRA, Pub. L. No. 104-67, 109 Stat. 737, "to enact reforms to protect investors and maintain confidence in our capital markets" by avoiding the deleterious effects of "abusive and meritless" private securities litigation. H.R. Conf. Rep. No. 104-369, at 31 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 730 ("Conference Report"). In so doing, Congress recognized private securities litigation as "an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action" and that, consequently, such lawsuits "promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." *Id.* Through the PSLRA, Congress sought "to return the securities litigation system to that high standard." *Id.* In striking this balance, Congress sought to weed out meritless claims at an early stage, but also wanted meritorious claims to proceed. *Id.*

Adopted "to encourage issuers to disseminate relevant information to the market without fear of open-ended liability," Section 102 of the PSLRA amended the Securities Act and the Exchange Act to add a safe harbor to "protect[] from liability in private lawsuits certain 'forward-looking' statements . . . ." *Id.* at 32, 43. *See* 109 Stat. 749 (adding Section 27A to the Securities Act, 15 U.S.C. § 77z-2, and Section 21E to the Exchange Act, 15 U.S.C. § 78u-5). The safe harbor is "based on aspects of SEC Rule 175 [17 C.F.R. § 230.175] and the judicial[ly] created 'bespeaks caution' doctrine." Conference Report at 43. [2/]

As enacted by Congress, the safe harbor applies "to a forward-looking statement made by . . . an issuer that, at the time that the statement is made, is subject to the reporting requirements of [Exchange Act] section 13(a) or section 15(d)" or "a person acting on behalf of such issuer . . . ." Exchange Act Section 21E(a)(1)-(2). Excluded from this coverage, however, is any forward-looking statement that is "included in a financial statement prepared in accordance with generally accepted accounting principles . . . ." Section 21E(b)(2).

[2/] Rule 175 provides a safe harbor for forward-looking statements included in registration statements and reports filed with the Commission if the statements were made with reasonable bases and in good faith.

Regarding the protection from liability, Section 21E(c)(1) provides:

> [I]n any private action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, [a covered person] shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that—
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> (A) the forward-looking statement is—
>
> (i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
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> (ii) immaterial; or
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> (B) the plaintiff fails to prove that the forward-looking statement—
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> (i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
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> (ii) if made by a business entity, was—
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> (I) made by or with the approval of an executive officer of that entity, and
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> (II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.

B. This Litigation

Amex is a publicly traded financial services corporation. During the relevant period, AEFA was an Amex subsidiary that provided a variety of financial products including insurance and annuities. On July 18, 2001, Amex issued a press release announcing that it would be recognizing an $826 million loss, largely due to write-downs of AEFA investments in high-yield debt. That day, the company's stock price dropped 3.3%, from $38.78 per share to $37.50 per share. On July 17, 2002, investors who purchased Amex common stock between July 26, 1999, and July 17, 2001, filed a number of actions in the United States District Court for the Southern District of New York, alleging that Amex and certain individual officers had knowingly issued false and misleading statements leading up to the July 18, 2001, announcement in violation of

Exchange Act Section 10(b) and Rule 10b-5, and seeking to hold certain individual defendants liable as "controlling persons" under Exchange Act Section 20(a). [3/]

After the individual cases were consolidated and lead plaintiffs and counsel were appointed, plaintiffs filed an amended class action complaint, which the district court dismissed as time-barred and for failure to state a claim. *See In re Am. Express Co. Sec. Litig.*, No. 02 Civ. 5533, 2004 WL 632750 (S.D.N.Y. Mar. 31, 2004). This Court reversed and remanded, granting plaintiffs leave to amend their allegations. *See Slayton v. Am. Express Co.*, 460 F.3d 215 (2d Cir. 2006).

In response to this Court's decision, plaintiffs filed a Second Amended Complaint ("SAC"), in which they allege, *inter alia*, that Amex issued false and misleading public statements in early 2001 that attempted to minimize the amount of damage to AEFA's portfolio. SAC ¶¶ 262-63 (A. 233-34). Among other things, plaintiffs claim that the statement in Amex's May 2001 Form 10-Q that "[t]otal losses on [AEFA's high-yield investments] are expected to be substantially lower than in the first quarter" was false and misleading since "the Company and the other Defendants had no basis for making this representation," "were aware of contradictory information," and "knew that the particular forward-looking statement was false . . . ." SAC ¶¶ 230-34, 295 (A. 223-25, 244). In support of this allegation, plaintiffs further allege that:

> 231. Specifically, in early May, 2001, *before* American Express had filed its Form 10-Q with the SEC for the first quarter of 2001, Defendant [Cracchiolo, AEFA's CEO] received a fax from AEFA's CFO advising him that American Express was facing additional losses on its high-yield debt investments beyond those already booked. Defendant Chenault [Amex's president] was specifically advised of this situation a day later, during a visit to AEFA's Minneapolis headquarters, and was informed that the deterioration of the high-yield debt portfolio was so bad that even the investment grade CDOs held by American Express were likely damaged, due to the fact that defaults in underlying bonds had increased so sharply.
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> 232. As a result, the Company brought in former American Express Treasurer Walter Berman, who had rejoined the Company, and Senior Risk Management Vice President David Yowan, working with a team of in-house American Express analysts, to assess the damage.

[3/] The remaining individual defendants in the case are: Harvey Golub, the company's Chairman and Chief Executive Officer until late 2000; Kenneth I. Chenault, the company's President, Chief Operating Officer, and successor to Golub; David R. Hubers, President and Chief Executive of AEFA; and James M. Cracchiolo, Amex President of Global Financial Services, and AEFA's Chief Executive Officer and Chairman.

233. However, this represented the first time American Express or AEFA had performed a comprehensive internal valuation of these high-yield CDO investments. Previously, they had largely relied on outside parties such as CDO managers to evaluate those instruments. Messrs. Berman and Yowan estimated a necessary $400 million in additional necessary write-downs, a figure that understated the real picture by another $426 million.

234. Incredibly, however, despite the fact that Defendants Chenault and Cracchiolo had been expressly informed in early May 2001 that the $185 million first quarter write-down did not reflect the true magnitude of the deterioration of AEFA's high-yield debt portfolio, American Express nevertheless included the following statement in its first quarter 2001 Form 10-Q filed on May 15, 2001: ***"Total losses on these [high-yield] investments for the remainder of 2001 are expected to be substantially lower than in the first quarter [of 2001]."*** Defendants failed to correct or qualify this statement over the next two months, leaving investors in the dark until American Express shocked the market in mid-July 2001 with an $826 million write-down of AEFA's high-yield debt investments.

(A. 224-25, emphasis in original). [4]

Finding that plaintiffs' allegations in the SAC did not adequately plead facts sufficient to give rise to a "strong inference" that the defendants made any of the alleged false or misleading statements with scienter, the district court dismissed the SAC for failure to state a claim. *See In re Am. Express Co. Sec. Litig.*, No. 02 Civ. 5533, 2008 WL 4501928 (S.D.N.Y. Sept. 26, 2008). The plaintiffs appealed only from the district court's dismissal of the allegations regarding Amex's statement in the May 2001 Form 10-Q that the high-yield losses for the remainder of 2001 "are expected to be substantially lower than in the first quarter."

ANALYSIS

I. The MD&A Section of a Form 10-Q Is Not Part of a "Financial Statement Prepared in Accordance with [GAAP]."

Section 21E(b)(2)(A) excludes from the safe harbor forward-looking statements that are "included in a financial statement prepared in accordance with [GAAP]." Here, the forward-looking statement at issue was made in the MD&A section of Amex's May 2001 Form 10-Q. The Court has asked whether a forward-looking statement made in the MD&A section of a Form 10-Q is one that is "included in a financial statement prepared in accordance with [GAAP]," and thus falls within the statutory exclusion from the safe harbor. In the Commission's view, the

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[4] The Commission, of course, expresses no view as to the accuracy of plaintiffs' allegations.

challenged statement is not excluded from the safe harbor under Section 21E(b)(2)(A); the MD&A section is separate and distinct from the financial statements of a Form 10-Q. The Commission has recognized that "[w]hile the statutory safe harbors by their terms do not apply to forward-looking statements included in financial statements prepared in accordance with U.S. GAAP, they do cover MD&A disclosures." *Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, Securities Act Release No. 8182 (Apr. 7, 2003), 68 Fed. Reg. 5982, 5993 n.146 (Feb. 5, 2003).

As an initial matter, it appears that Congress was aware of the distinction between financial statements and MD&A, as it expressly included "statement[s] of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission" in the definition of a "forward-looking" statement (*see* Section 21E(i)(1)(C)), but excluded forward-looking statements that were "included in a financial statement prepared in accordance with [GAAP]" from the safe harbor.

This view of financial statements and MD&A as separate and distinct is consistent with the Commission's treatment of financial statements and MD&A, which, as set forth below, are required as separate items of Part I of Form 10-Q, 17 C.F.R. § 249.308a, and are governed by different disclosure rules and regulations.

- *Financial Statements*. Regulation S-X sets forth "the form and content of and requirements for financial statements required to be filed as part of . . . [r]egistration statements . . . , annual or other reports," which "include[s] all notes to the statements and all related schedules." Rule 1-01 of Regulation S-X, 17 C.F.R. § 210.1-01. Item 1 (Financial Statements) of Form 10-Q requires disclosure of interim financial statements as set forth in Rule 10-01 of Regulation S-X, 17 C.F.R. § 210.10-01. Rule 10-01 specifies what materials are required in interim financial statements: an interim balance sheet, interim statement of income, and interim statement of cash flows. *Id.*

- *MD&A*. Regulation S-K sets forth "the requirements applicable to the content of the *non-financial statement portions* of . . . [r]egistration statements . . . [and] annual or other reports . . . ." Item 10 of Regulation S-K, 17 C.F.R. § 229.10 (emphasis added). Item 2 of Form 10-Q requires disclosure of the information required by Item 303 of Regulation S-K, 17 C.F.R. § 229.303, which is the MD&A.

Including MD&A as a separate item of disclosure evolved over time. In 1968, the Commission issued guidance on the preparation and filing of registration statements that, among other things, discussed the Summary of Earnings section of registration statements and suggested the inclusion of an MD&A-like discussion when "the prospectus contains a discussion of factors indicating an adverse change in operating results subsequent to the latest period included in the summary of earnings . . . ." *Guides for Preparation and Filing of Registration Statements*, Securities Act Release No. 4936, 33 Fed. Reg. 18617, 18620 (Dec. 17, 1968). In 1974, the Commission issued guidance that provided for the inclusion of a "Management's Discussion and Analysis of the Summary of Earnings" and "Summary of Operations" under the appropriate section in registration statements and in periodic reports "[t]o enable investors to understand and evaluate material periodic changes in the various items of the summary of earnings" and "summary of operations." *Notice of Adoption of Amendments to Guide 22 of the Guides for Preparation and Filing of Registration Statements under the Securities Act of 1933 and Adoption of Guide 1 of the Guides for Preparation and Filing of Reports and Registration Statements under the Securities Act of 1934*, Securities Act Release No. 5520, 39 Fed. Reg. 31894, 31895, 31896 (Sept. 3, 1974). More recently, the Commission noted that the MD&A section should provide "a discussion and analysis of a company's business as seen through the eyes of those who manage that business," which "should not be a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements, neither of which provides this important management perspective." *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, Securities Act Release No. 8350, 68 Fed. Reg. 75056, 75056 (Dec. 29, 2003) ("MD&A Guidance Release"). [5/]

II. Although the May 2001 Form 10-Q Adequately Identified the Forward-Looking Statement, the Cautionary Language Was Not Sufficiently "Meaningful" To Receive Safe-Harbor Protection.

A. Amex's Method of Identifying Forward-Looking Statements Was Adequate.

Section 21E(c)(1)(A)(i) requires that, to receive safe-harbor protection, a statement must be "identified as a forward-looking statement . . . ." The Court has asked whether, to satisfy this requirement, a statement need be included under a separate "Forward-Looking Statements" section, or be specifically labeled as a "forward-looking statement," or whether it is sufficient to include a note at the end of a Form 10-Q, as Amex did in its May 2001 Form 10-Q, to the effect

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[5/] Viewing the financial statements and MD&A as separate and distinct is also supported by both the accounting and auditing literature. For example, Basis for Conclusions ¶ A8 (from Appendix A) of Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*, No. 168, states that the codification project to organize and simplify authoritative GAAP literature "does not include content related to matters outside the basic financial statements, such a management's discussion and analysis . . . ." Similarly, PCAOB's Interim Attestation Standards identify MD&A as a separate engagement distinct from an audit of financial statements. *See, e.g., PCAOB Standards and Related Rules*, AT 701 Management's Discussion and Analysis (setting forth standards and guidance "concerning the performance of an attest engagement with respect to [MD&A] prepared pursuant to [SEC] rules and regulations").

that "[t]he words 'believe', 'expect', 'anticipate', 'optimistic', 'intend', 'aim', 'will', 'should' and similar expressions are intended to identify [] forward-looking statements."

The facts and circumstances of the language used in a particular registration statement or report will determine whether or not a forward-looking statement is sufficiently identified to receive safe-harbor protection. Although there is no bright-line test for whether a forward-looking statement is sufficiently identified, the Commission has provided general guidance for MD&A that encourages companies to present information in "clear and understandable language" and to "avoid unnecessary duplicative disclosure that can tend to overwhelm readers and act as an obstacle to identifying and understanding material matters." MD&A Guidance Release , 68 Fed. Reg. at 75057, 75059.

As a general matter, we do not believe that to sufficiently identify forward-looking statements consistently with that guidance and the statute an issuer must include all forward-looking statements in a separate section or label each forward-looking statement as such. To satisfy Section 21E(c)(1)(A)(i), issuers can adequately identify a forward-looking statement, as Amex did here in its May 2001 Form 10-Q, by including an explanatory note indicating that the use of certain forward-looking words is intended to identify a forward-looking statement. The use of linguistic cues like "we expect" or "we believe," when combined with an explanatory description of the company's intention to thereby designate a statement as forward-looking, generally should be sufficient to put the reader on notice that the company is making a forward-looking statement.

B. Amex's Misleading Risk Disclosure Cannot Be Considered A Meaningful Cautionary Statement.

Section 21E(c)(1)(A)(i) provides that a forward-looking statement that "is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement" is protected under the safe harbor. The Court has asked what constitutes "meaningful cautionary statements" and, specifically, whether Amex's statement that "potential deterioration in the high-yield sector . . . could result in further losses in [AEFA's] investment portfolio" satisfies this standard. In the Commission's view, this disclosure was not "meaningful" under the safe harbor provision, because, according to plaintiffs' allegations, it is misleading in light of a historical fact—it warned of "*potential* deterioration in the high yield sector" that Amex officials were aware was *actually occurring* at the time.

Whether cautionary language satisfies the safe harbor depends on the facts and circumstances of each case, specifically the cautionary language and the forward-looking statement it is intended to address. Adverting to the judicially-created "bespeaks caution" doctrine, the Conference Report states that "boilerplate warnings will not suffice as meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement," but rather, "cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer's business." Conference Report at 43. *See In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371-72 (3d Cir. 1993) (cautionary language "must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge"). Although an issuer is not required to identify all known risk factors if the factors it does disclose constitute "meaningful" cautionary language "that could cause actual results to differ materially" from the forward-looking statement, "[a] cautionary statement that misstates historical facts is not covered by the safe harbor . . . ." Conference Report at 44.

Accordingly, in applying the bespeaks caution doctrine and the PSLRA's safe harbor, courts (including this Court) have held that the doctrine "'provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.'" *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004) (quoting *In re Prudential Sec. Inc. P'ships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996)). *See also Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 640 (D.C. Cir. 2008) (same); *Lormand v. US Unwired, Inc.*, 565 F.3d 228, 247 (5th Cir. 2009) (finding inadequate "warnings about . . . future risk of *limited* magnitude that would be averted rather than certain dangers that had already begun to materialize"); *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 709 (3d Cir. 1996) (finding "bespeaks caution" doctrine did not apply because "a reasonable investor would be very interested in knowing, not merely that future economic developments might cause further losses, but that (as plaintiffs allege) current reserves were known to be insufficient under current economic conditions"); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981) ("To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit."), *rev'd in part on other grounds*, 459 U.S. 375 (1982). The Commission has taken this same approach in its administrative proceedings. *See, e.g., Dolphin & Bradbury, Inc.*, Securities Act Release No. 8721, at 15 (July 13, 2006).

Amex's risk disclosure that "potential deterioration in the high-yield sector . . . could result in further losses in AEFA's investment portfolio" fails to qualify as "meaningful" under the safe harbor for this reason. According to plaintiffs' allegations, at the time that defendants were warning of *potential* deterioration in the high yield sector, they were aware that such deterioration was *actually occurring*. *See* SAC ¶¶ 230-34, 295 (A. 223-25, 244). As this Court and others have held, it is misleading and therefore insufficient under the "bespeaks caution" doctrine and the safe harbor for a company to warn of a potentiality that it is aware currently exists. Safe harbor coverage does not (nor should it) apply where the cautionary statement is itself misleading.

There is, moreover, no reason to believe that, in adopting the safe harbor, Congress intended to deviate from the well-established proposition that misleading cautionary language does not render inactionable a false or misleading forward-looking statement. Far from embracing such a departure from this aspect of the "bespeaks caution" doctrine, in fact, the

Conference Committee expressly recognized that an issuer could not rely upon a cautionary statement "that misstates historical facts . . . ." Conference Report at 44. Thus, even though the Conference Report elsewhere indicates that the Committee intended "to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss, without examining the state of mind of the defendant," this statement was made to emphasize a much different point. *Id.* at 43-44. Namely, the Committee made this statement in explaining that the safe harbor was intended to protect issuers who satisfied this prong of the safe harbor—by disclosing "meaningful cautionary statements identifying important factors"—from securities fraud claims alleging that the issuer failed to disclose *all* known sources of risk, even if the issuer failed to disclose the factor that caused the forward-looking statement not to come true. *Id.* at 44 ("The Conference Committee expects that the cautionary statements identify important factors that could cause results to differ materially—but not all factors. Failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor. The Conference Committee specifies that the cautionary statements identify 'important' factors to provide guidance to issuers and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made."). The Committee's admonition against "examining the state of mind of the defendant," therefore, is limited to the context of prohibiting actions based upon a failure to disclose one of many known risks where the issuer's cautionary statements are otherwise adequate under the safe harbor, and has no bearing on the Committee's explicit recognition that a misleading cautionary statement is not entitled to safe-harbor protection.

III. A Speaker Who Makes a Forward-Looking Statement with Actual Knowledge that He or She Has No Reasonable Basis Upon Which To Make the Statement Has Actual Knowledge that the Statement Is Misleading.

Section 21E(c)(1)(B) states that a person is not liable with respect to a forward-looking statement if the plaintiff fails to prove that the statement was made "with actual knowledge . . . that the statement was false or misleading." The Court has inquired whether, and to what extent, the statute's "actual knowledge" requirement differs from recklessness, and whether "actual knowledge that [a] statement was . . . misleading" may be established by proof that the speaker lacks a reasonable basis, or any basis at all, upon which to make the statement.

In the Commission's view, a forward-looking statement is made with "actual knowledge" that it is misleading if the speaker makes the statement with the knowledge that he or she had no reasonable basis, or no basis at all, upon which to make it. "A statement is misleading when, although literally true, it implies something that is false." *Mead Johnson & Co. v. Abbott Labs.*, 209 F.3d 1032, 1034 (7th Cir. 2000). A statement of prediction or expectation, like Amex's statement that "losses . . . *are expected* to be substantially lower," contains at least three implicit factual assertions, including (i) that the statement is genuinely believed; (ii) that there is a reasonable basis for that belief; and (iii) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. *See, e.g., In re Apple Computer*

Sec. Litig., 886 F.2d 1109, 1113 (9th Cir. 1989). Consequently, courts have long held that a forward-looking statement made where any of these implicit representations is false is actionable under the antifraud provisions of the federal securities laws. *See, e.g., City of Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 399 F.3d 651, 675 (6th Cir. 2005); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 557 (6th Cir. 2001) (*en banc*); [6/] *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994); *In re Apple Computer Sec. Litig.*, 886 F.2d at 1113; *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489-92 (9th Cir. 1974). It follows, then, that a speaker has "actual knowledge" that a forward-looking statement is misleading if the speaker actually knows that one or more of these implicit factual representations is not true.

For example, in *Helwig*, 251 F.3d 540, the Court of Appeals for the Sixth Circuit, sitting *en banc*, held that a company had "actual knowledge" under the PSLRA safe harbor that its optimistic forward-looking statements and projections regarding the effect that pending legislation would have on its business were misleading because executives at the company were aware of the legislation's potential negative impact. *Id.* at 557. "'A defendant who asserts a fact as of his own knowledge or so positively as to imply that he has knowledge, under the circumstances when he is aware that he will be so understood when he knows that he does not in fact know whether what he says is true,'" the court explained, "'is found to have intent to deceive, not so much as to the fact itself, but rather as to the extent of his information.'" *Id.* at 558 (quoting *Prosser & Keaton on Torts* 741-42 (5th ed. 1984)). *See also City of Monroe*, 399 F.3d at 675 ("we conclude that a reasonable juror in this case could conclude that Firestone's statement . . . carried with it the representation that there was a reasonable basis for that belief, and that Firestone was not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement, and that both those representations were misleading").

To be clear, this standard is distinct from, and requires more than, a showing that a speaker acted recklessly in making a misleading forward-looking statement. Although the PSLRA's legislative history is unilluminating on the matter, the plain language of the provision requiring "actual knowledge" indicates that, to avoid the safe harbor, a plaintiff needs to show more than that a defendant acted recklessly. [7/] Recklessness is defined as "an extreme departure

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[6/] *Helwig*'s interpretation of the PSLRA's "strong inference" pleading requirement for pleading scienter in a private action for securities fraud was overruled by *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313-14 (2007). The holding in *Helwig* on which we rely remains good law.

[7/] The legislative history reveals little about the choice of "actual knowledge" as the safe harbor's scienter standard. An earlier version of the legislation (S. 240) would have protected false or misleading forward-looking statements unless the plaintiff proved that it was "knowingly made with the expectation, purpose, and actual intent of misleading investors," which was a standard the Commission criticized as having the potential "'to preclude all but the most obvious frauds'" and which would "'allow willful fraud to receive the benefit of safe harbor protection.'"

(continued...)

from the standards of ordinary care . . . to the extent that the danger was either known to the defendant *or so obvious that the defendant must have been aware of it*." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978) (emphasis added) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)); *see also Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (same). The "must have been aware" basis for showing recklessness permits a court to impute knowledge to a defendant based on facts that would have made the risk of misleading investors obvious to a reasonable person—an objective inquiry. *See Sundstrand*, 553 F.2d at 1045 ("the danger of misleading buyers must be actually known or *so obvious that any reasonable man would be legally bound as knowing*") (emphasis added). This recklessness standard also has a subjective component, which provides that a defendant cannot be reckless if he acts without subjective consciousness of the facts that make the statement or omission so "obviously" misleading; instead, the defendant's misstatement or omission "must derive from something more egregious than even 'white heart/empty head' good faith" or "inexcusable neglect." *Id.* In an omissions case, for example, if a defendant "genuinely forgot to disclose information or [if] it never came to his mind, etc.," the subjective prong "would defeat a finding of recklessness even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045, n.20. This is distinct, however, from actual, subjective knowledge that a statement or omission is misleading. *Id.* at 1046 (a finding of "the objective obviousness of the danger" was "sufficient for liability even absent an actual appreciation by [the defendant] of the significance of" the omission that was the basis of the fraud claim); *see also Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008) ("When the facts known to a person place him on notice of a risk, he cannot ignore the facts and plead ignorance of the risk.").

By contrast, to remove a forward-looking statement from the protection of the safe harbor, a plaintiff must show that the defendant (i) *actually knew* (ii) that the statement was misleading. In other words, to survive a motion to dismiss, the plaintiff must plead facts sufficient to establish the defendant was subjectively aware that one of the implicit factual assertions underlying its forward-looking statement was false when the statement was made. The

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S. Rep. No. 104-98, at 37 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 721 (Additional Views of Senators Sarbanes, Bryan, and Boxer, quoting May 25, 1995, letter from SEC Chairman Levitt to the members of the Senate Banking Committee). This standard, however, was not included in the final bill that was agreed to by the Conference Committee. The Conference Report merely tracks the language of the bill, by stating that "[a] person or business entity will not be liable in a private lawsuit for a forward-looking statement unless a plaintiff proves that person or business entity made a false or misleading forward-looking statement with actual knowledge that it was false or misleading." Conference Report at 44.

parties dispute whether plaintiffs' allegations satisfy this standard here—a pleading issue on which the Commission takes no position.

Respectfully yours,

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