

# INSIGHTS

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## SECURITIES DISCLOSURE

### Writing Effective Risk Factor Disclosure in Offering Documents and Exchange Act Reports

*The SEC has proposed to extend risk factor disclosure to annual and quarterly reports. Effective risk factor disclosure alerts existing and potential investors to risks specific to the company or its industry, and protects the company from risks of liability based on statements or omissions in its public filings.*

by **Robert B. Robbins and Philip L. Rothenberg**

Risk factors, which have long been an important part of S-1 registration statements and annual reports for foreign private issuers on Form 20-F, may now become a regular part of US public companies' annual reports on Form 10-K and periodic reports on Form 10-Q. In the November 17, 2004, Securities and Exchange Commission (SEC) rule proposal dealing with securities offering reform,<sup>1</sup> the SEC proposed to extend risk factor disclosure to quarterly and annual reports. Similar to risk factor disclosure in registration statements filed with the SEC, risk factor disclosure in annual reports on Form 10-K would "describe the most significant factors that may adversely affect the issuer's business, operations, industry or financial position, or its future financial performance," would

be governed by Item 503 of Regulation S-K and would have to be written in plain English per Rule 421 under the Securities Act of 1933. Additionally, risk factor disclosure would have to be updated in quarterly reports on Form 10-Q to reflect any material changes from previously disclosed risk factor disclosure in Exchange Act reports.<sup>2</sup>

As the SEC is proposing to make risk factor disclosure a regular part of a public company's annual and quarterly disclosure on Forms 10-K and 10-Q (Exchange Act Reports), it is important for public companies and their counsel to understand risk factors and their purpose, to review the rules that deal with risk factor disclosure and to understand best practices in order to be able to draft effective risk factor disclosure.

### What Are Risk Factors?

Risk factors are one of the main features of registration statements on Forms S-1, F-1 and 20-F, and are also prevalent in offering documents such as prospectuses or offering memorandum under Rule 144A and/or Regulation S (collectively, Offering Documents).<sup>3</sup> Traditionally, risk factors alert existing and potential investors to risks specific to the company or its industry that make an offering speculative or high risk. In Exchange Act Reports, risk factors will presumably alert potential and current investors as to the risks of either purchasing or continuing to own the company's stock. Risk factors present a summary of the risks facing the company, and therefore identify to existing and

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potential investors, factors that should be considered when making an investment decision.<sup>4</sup>

The “Risk Factors” section should present a concise synopsis of risks that are explained in more detail in other places in the annual or quarterly report.<sup>5</sup> Companies and their counsel who are drafting and revising risk factors must anticipate potential problems facing the company and describe them to existing and potential investors.<sup>6</sup> As the SEC has noted that “only through the steady flow of timely, comprehensive and accurate information can people make sound investment decisions,”<sup>7</sup> it is important that risk factors in both Offering Documents and Exchange Act Reports comprehensively cover important risks facing the company and present such information as of the date of publication.

### **SEC Rules Regarding Risk Factors**

Regulation S-K Items 501 and 503 deal with risk factors. Item 501(b)(5) states that the outside front cover page of the prospectus must contain a cross-reference to the risk factors section, including the page number where it appears in the prospectus. In addition, this cross-reference to the Risk Factor section must be highlighted by prominent type or in another manner. Most companies comply with this rule by using bold, underline, italics, larger font size or some combination thereof to highlight the cross reference.

Item 503(c) describes what must be included in the section entitled “Risk Factors.” It states that risk factors should be concise and organized logically, while also noting that “risks that could apply to any issuer or any offering” should be avoided. Each risk should be set forth under a heading that adequately describes the risk. In Offering Documents, the risk factor discussion must appear directly after the summary section.<sup>8</sup> Item 503(c) provides a few examples of typical risk factors, including those dealing with a company’s lack of operating history, lack of profitability, financial position, business or lack of a market for the company’s securities. Other typical risk factors include those dealing with possible litigation, competition,<sup>9</sup> future capital needs, dependence on key personnel, government regulation, and other factors unique to the company or its industry.

In addition, in 1999 the SEC published the Division of Corporation Finance: Updated Staff Legal Bulletin No. 7 (Updated SLA7)—“Plain English Disclosure,” which has a section entitled “Risk Factor Guidance.” In this section, the SEC Staff provides two examples of risk factors that have been staff e-written so that the risks are specifically linked to either the company or its industry, the risks themselves are more fully elucidated and the presentation uses various plain English principles to make the risk factors easier to read, including shorter sentences and bullet point lists. In addition, Updated SLA7 provides some sample comments to risk factors.<sup>10</sup>

Rule 421(d) of Regulation C requires that the risk factors section be written using plain English principles.<sup>11</sup> The six basic plain English principles that must be followed are:

1. Short sentences;
2. Definite, concrete, everyday words;
3. Active voice;
4. Tables or bullet point lists, whenever possible;
5. No legal jargon and highly technical business terms; and
6. No multiple negatives.

The adopting release for the SEC’s plain English requirements also noted that the risk factors section must be designed to make it easy to read and the text should be formatted to highlight important information for investors.<sup>12</sup> These rules emphasize the need to make each risk factor heading stand out and to keep each risk factor concise and focused.

### **Categories of Risk Factors**

In general, risk factors fall into three broad categories: (1) industry risks, (2) company risks, and (3) investment risks.

1. “Industry risks” are those that companies face by virtue of the industry they in which they participate. For example, automobile manufacturers may face a risk that they will not be able to acquire raw materials such as steel and plastic in sufficient quantities, at reasonable prices and levels of quality to continue to meet production demands.

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2. “Company risks” are those that are specific to the company. For example, while General Motors or Ford may face a risk that unionized employees may strike therefore decreasing output and consequentially negatively effecting revenues and profits, Toyota and Honda may not have similar problems due to fewer occurrences of union dissatisfaction with management.
  3. “Investment risks” are those that are specifically tied to a security. For example, in an initial public offering, a common risk is that a liquid market for the securities being offered might not develop.

Each risk factor should be specifically linked to the company’s industry, to the company itself or to an investment in the company’s securities.

### **Should Risk Factors Be Long and Detailed or Short and to the Point?**

Risk factors should be fairly short, a paragraph or two, and written so that the important point is conveyed as concisely as possible. Risk factors should get to the point quickly. The SEC has noted, however, when discussing plain English in the context of disclosure, that the goal is clarity, not brevity, and that “writing disclosure in plain English can sometimes increase the length of particular sections of your prospectus.”<sup>13</sup>

Substance should not be sacrificed for brevity, but risk factors are meant to be summaries of important risks facing the company which can be more fully explained in other parts of the Offering Document or Exchange Act Report. As a general matter, each risk factor should focus on a single, principal risk, as the SEC staff often comments that multiple risks should not be “bundled” into a single risk factor. (*Editor’s Note: For typical SEC Staff comments concerning risk factors, see box accompanying this article.*)

### **Are Countervailing Considerations an Acceptable Part of Risk Factors?**

No. Companies should not on the one hand warn potential investors or current shareholders about a potential risk they face and then on the other hand try to explain away all or part of such risk. This greatly diminishes, if not completely erodes, the value of the

warning that the risk factor is meant to convey and therefore greatly decreases the legal protection afforded to companies by including the risk factor.

### **Should Risk Factors Include Examples?**

If possible, yes. It is a good idea to include specific examples demonstrating the type of risk that the company is trying to describe, if such examples exist. For example, if the risk is that future product recalls may hurt the company’s revenues, results of operations and reputation, a sentence describing a similar recall the company recently undertook could be added. Such examples should be updated periodically in risk factors in Exchange Act Reports by removing old examples and replacing them with newer ones.

### **Can There Be Too Few or Too Many Risk Factors?**

If the Offering Document or Exchange Act Report contains too few risk factors, investors or current shareholders might not be aware of potential risks. This can increase the company’s risk of liability in future shareholder litigation. If the Offering Document or Exchange Act Report contains too many risk factors, however, important risks could be obscured, which also can increase the company’s risk of liability.<sup>14</sup> This is not to say that a company should exclude risks that are meaningful but minor, but the addition of “boilerplate” risk factors (*i.e.*, ones that could apply to any company or any offering<sup>15</sup>) should probably be avoided unless they specifically apply to the company. In general, companies should avoid stating obvious risks and instead try to focus on the risks which management truly are concerned about in the daily and long-term management of the company. Risk factors which are not specifically tailored to an individual company and the risks it faces do not protect against liability.<sup>16</sup>

### **Risk Factors—A Company’s Best Friend**

By providing disclosure of material risks of loss, risk factors limit the likelihood that a company will have liability to its shareholders if such a risk of loss should come to pass. Risk factors can help protect the company from losing a shareholder lawsuit by helping to refute the claim that the company did not warn the shareholder of the possibility that something bad could

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occur.<sup>17</sup> Hindsight being 20/20, companies that cannot point to such a risk factor when faced with a lawsuit will wish they could turn back the clock and insert such language. Risk factors therefore are often referred to as the “cheapest form of insurance.”

### **The “Bespeaks Caution” Doctrine**

The “bespeaks caution” doctrine refers to a line of judicial decisions holding that statements of future forecasts, projections and expectations in an offering document are not misleading so long as they contain adequate cautionary language disclosing specific risks. The cautionary language used to disclose risks must be specific, not just boilerplate language, as well as linked to the forecasts, projections and expectations.<sup>18</sup> Cautionary language in an offering document can reduce the ability of a disappointed investor to claim that the risks of the investment were not properly described in the offering document.<sup>19</sup>

If used properly, cautionary language such as risk factors in an Offering Document or Exchange Act Report can alter the total mix of available information and thereby help insulate certain forward-looking statements from successful future challenge.<sup>20</sup> For example, in the case of *In re Donald Trump Securities Litigation*,<sup>21</sup> the US Court of Appeals for the Third Circuit applied the bespeaks caution doctrine to a case involving disgruntled bond holders of the Taj Mahal casino, and decided against the bondholders because the abundant and meaningful cautionary language in the bond prospectus were of the type “that bespeak caution.”<sup>22</sup>

Many public companies currently take advantage of the bespeaks caution doctrine and the safe harbor for “forward looking statements” under the Private Securities Litigation Reform Act of 1995<sup>23</sup> by including cautionary language in their Exchange Act Reports. Such cautionary language is usually found in or near the section entitled “Management’s Discussion and Analysis of Financial Condition and Result of Operations.”<sup>24</sup> For example, Microsoft Corporation’s annual report on Form 10-K for the fiscal year ended June 30, 2004, contains a section called “Issues and Uncertainties” that states that the Form 10-K contains forward-looking statements and goes on to provide risk factor-like disclosure.<sup>25</sup> Ford Motor Company’s

annual report on Form 10-K for the fiscal year ended December 31, 2004, has a section titled “Risk Factors” in which it provides a page of bullet points detailing risks, uncertainties and other factors that could cause actual results to differ from the disclosed forward-looking statements. If the SEC’s rule proposal dealing with securities offering reform is adopted in its current form, such forward-looking statement disclosures will be the starting point for companies when drafting their risk factor disclosure.

### **Characteristics of a Good Risk Factor/Good Risk Factor Section**

Good risk factors are concise, well-written and easy-to-read, with concrete examples and enough detail to fully convey the particular risk. They are carefully tailored to the specific risks that the company faces in the current business environment. Risk factors should be prioritized in the order of their importance to the company (*i.e.*, the most serious/threatening ones come first, in descending order of importance and potential magnitude to the company).<sup>26</sup> The lead sentence in each risk factor, which usually appears in bold, italics or both, should reflect the specific nature of the risk factor. Subheadings in the risk factor section, such as “Risks related to our company,” “Risks related to our industry,” “Risks related to this offering” or any other appropriate subheadings should be used to make risk factors easier to read.

### **Where Can a Company Find Good Examples of Risk Factors?**

Construction of the risk factors section can seem a daunting task for counsel, who must decide how to give appropriate weight to different risk factors that often can be difficult to compare. If the company has prior public filings, any new risk factors section must be drafted with a view to the risk factor disclosures that have been made in the past, as the market may place unjustified significance on changes in the wording of particular risk factors. There is no substitute for thorough due diligence by counsel to understand the company, its industry and other companies in the same industry. News articles, company press releases, the material on its Web site, reports of securities analysts and even the discussions in Internet chat rooms can provide useful background for understanding a compa-

## Typical SEC Staff Comments on Risk Factors

- We suggest that you revise your risk factor captions to make your disclosure more meaningful to your investors and shareholders. Some of your risk factors merely state a fact about your business. You should succinctly state in your captions the particular risk that results from the uncertainty.
- Provide only that amount of detail necessary to understand the risk faced by investors. Avoid extraneous information and unnecessary background. In addition, get to the risk as quickly as possible. Revise your risk factors so that you present the specific risk in the first or second sentence. Eliminating excess detail will aid you in doing this.
- In each risk factor, get to the risk as quickly as possible and provide only enough detail to place the risk in context. In some of your risk factors, the actual risk you are trying to convey does not stand out from the extensive detail you provide. For example, what specifically is the risk in the first risk factor? The first paragraph explains in detail Company X's past losses without any reference to a current risk.
- Some of your risk factor captions are too vague and generic and do not adequately describe the risk that follows. Readers should be able to read the risk factor heading and come away with a strong understanding of what the risk is and the result of the risk as it specifically applies to you. As a general rule, your revised subheadings should work only in this document. If they are readily transferable to other companies' documents, they are probably too generic. See Item 503(c) of Regulation S-K.
- Avoid presenting risks that could apply to any issuer in your industry, do not reflect your current operations, are not material, or are generic, boilerplate disclosures. Rather, tailor each risk factor to your specific facts and circumstances. To the extent that a risk is not material to you or your investors, consider whether you need to include it. For example:
  - "Our international investments may not produce the returns..."
  - "Rapid technological changes may adversely affect our business"
  - "Increased competition may reduce our market share and our revenues"
- Revise each risk factor to remove mitigating information. Generally, you should limit your Risk Factor section to an identification and brief description of each material risk. You may elaborate on the factors employed to minimize identified material risks within your Business section.
- Consider including a risk factor that addresses XYZ.
- Provide the information investors need to assess the magnitude of the risk. For example, in the second risk factor on page 4, you state that increases in short-term interest rates could have a material adverse effect on XYZ Bank's profitability. Explain why. Are a substantial percentage of XYZ's interest-earning assets in long-term investments that pay fixed rates while the interest you pay to your depositors fluctuates? If so, what percent of your interest-earning assets are in long-term investments?
- Many of your risk factors are too long. They are too long because you either provide too much detail regarding the risk, which obscures the risk addressed, or you combine several separate although related risks under one caption. Provide just enough detail to highlight the risk and present it in context. Include the full discussion of all related factors in the body of your document, such as in your MD&A or business sections.
- We note in the introductory paragraph to your risk factors section you state that this section is not complete, that there may be risks that you do not consider material now but may become material, or there may be risks that you have not yet identified. You must disclose all risks that you believe are material at this time. Delete this language from your introductory paragraph.
- Currently, it appears you are including more than one risk factor under one subheading. For example, is the second paragraph under "Recent Operating Results" a significant risk factor of this offering that needs to stand alone under an explanatory subheading? Other examples of "bundled" risk factors include... In order to give the proper prominence to each risk you present, we suggest you assign each risk its own descriptive subheading.
- Present the risks in more concrete terms. For example, in the first risk factor on page 12, you discuss the risks due to the "costs" associated with the benefit plans. So investors can better understand these risks, clearly state that the "costs" are not expenses of running those plans, but rather the added compensation expense that stems from the shares purchased or granted to employees and executives under those plans.
- The discussion of past losses appears elsewhere in the prospectus. Where you repeat later in the prospectus the details you currently include in your risk factors section, eliminate the extensive detail here. Instead, include a very brief overview to place the risk in context and provide a specific cross reference to the more detailed discussion elsewhere in the prospectus.
- Item 503(c) of Regulation S-K states that issuers should not "present risk factors that could apply to any issuer or to any offering." For example, the risk you disclose under "Dependence on Key Personnel" could apply to nearly any issuer in your industry and even in other industries. If you elect to retain these and other general risk factors in your prospectus, you must clearly explain how they apply to your industry, company, or offering. For example, explain why you are concerned you could lose these key personnel. Are they about to retire? Do you not have employment contracts with them?
- Revise each subheading to ensure it reflects the risk that you discuss in the text. Many of your subheadings currently either merely state a fact about your business, such as "Our capacity to borrow is limited" and "The services we provide are regulated," or describe an event that may occur in the future, such as "We may not be able to obtain the necessary regulatory approvals," and "We expect competition in our industry to increase." Succinctly state in your subheadings the risks that result from the facts or uncertainties.
- The subheadings in your risk factors section are too vague and generic to adequately describe the risk that follows. For example, on page X, you use the subheading "Competition." Because all companies operating in a free market economy are subject to competition, this subheading is not descriptive.
- To the extent possible, avoid the generic conclusion you make in most of your risk factors that the risk discussed would have a material adverse effect on your [operations] [financial condition] [business]. Instead, replace this language with specific disclosure of how your [operations] [financial condition] [business] would be affected.

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ny's risks. Most importantly, company management in different departments should be asked what they view as the most important risks facing the company. The more knowledgeable counsel is about the company, the more skilled counsel will be at anticipating problems the company will likely face.

Counsel also should review the filings of other companies in the same industry to see what kind of risk factors they have disclosed and what other companies in the same industry consider to be their most significant risks. These disclosures may indicate which questions might be appropriate to ask, but each company's risk factors must be individually tailored to fit the particular risks facing the company. If other companies in the same industry are negatively affected by certain developments, consider if the same or similar developments could happen to your company and whether the level of risk rises to level necessitating risk factor disclosure.<sup>27</sup>

No standard risk factors can take the place of careful analysis of the particular company. What types of risks does this type of company (*i.e.*, a company of this size, selling these products, in this industry, with these competitors) have under current economic conditions? What things have a realistic chance of going wrong in the company's business, or with the company itself, in the next 12 months which would be material to the company and thus important to tell the average investor?

## Conclusion

In most cases, the adequacy of a company's risk factors will never be known, because the potential adverse consequences will not occur and the company will not be called on to defend its disclosure. Because so few risk factors are put to the test of whether they have protected the company against liability, it often is difficult to determine what level of disclosure is appropriate, or what disclosure can be justified to the client.

At a threshold level, however, risk factors should be drafted to survive the test of review by the staff of the SEC Division of Corporation Finance. We therefore have included, in the box accompanying this article, a list of typical SEC comments received by companies

on their risk factor disclosure in offering documents for public offerings. We believe that it is useful, when judging draft risk factors, to consider to what extent the appended list of comments could fairly be made about one or more risk factors.

## NOTES

1. Release Nos. 33-8501; 34-50624 (November 17, 2004).
2. Restating or repeating risks in Form 10-Qs would not be required.
3. In prospectuses or offering memorandum under Rule 144A and/or Regulation S, companies wary of perceived negative publicity associated with having a section of the main marketing piece entitled "Risk Factors" will instead call the section "Investment Considerations " or "Certain Factors." For registration statements filed with the SEC, however, Item 503(c) of Regulation S-K mandates that this section be entitled "Risk Factors." Furthermore, Release No. 33-8501 proposes that the risk factor section in Form 10-Ks appear under the caption "Risk Factors."
4. In some contexts (*i.e.*, rescission offers), the SEC has viewed the term "investment decision" to include both the initial decision a potential investor makes to either purchase or not purchase a stock as well as the on-going decision, once an investor has decided to purchase a stock, whether to remain invested in the stock or to sell the stock.
5. See Form 20-F, Item 3.D., which states: "The Risk Factors section is intended to be a summary of more detailed discussion contained elsewhere in the document." The SEC frequently will comment that risk factors should be a shorter summary of potential problems facing the company which are detailed more extensively in other places in the registration statement, such as the "Business" section or Management's Discussion and Analysis (MD&A).
6. Company management can usually easily delineate the top risks facing the company, as these are the issues management deals with on a routine basis and around which at least part of the strategy of the company is based.
7. See "The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity" <http://www.sec.gov/about/whatwedo.shtml>.
8. If the offering document does not have a summary section, Risk Factors must "immediately follow the cover page of the prospectus or the pricing information section that immediately follows the cover page."
9. As do most companies that compete with Microsoft Corporation, Google disclosed in its initial public offering registration statement the following risk factor: "*We face significant competition from Microsoft and Yahoo.* We face formidable competition in every aspect of our business, and particularly from other companies that seek to connect people with information on the web and provide them with relevant advertising. Currently, we consider our primary competitors to be Microsoft Corporation and Yahoo! Inc. Microsoft recently introduced a test version of a new search engine and has announced plans to develop features that make web search a more integrated part of its Windows operating system. We expect that Microsoft will increasingly use its financial and engineering resources to compete with us. Yahoo has become an increasingly significant competitor, having acquired Overture Services, which offers Internet advertising solutions that compete with our AdWords and AdSense programs, as well as the Inktomi, AltaVista and AllTheWeb search engines.  
"Both Microsoft and Yahoo have more employees than we do (in Microsoft's case, currently more than 20 times as many). Microsoft also has significantly more cash resources than we do. Both of these companies also have longer operating histories and more established relationships with customers. They can use their experience and resources against us in a variety of competitive ways, including by making acquisitions, investing more

aggressively in research and development and competing more aggressively for advertisers and Web sites. Microsoft and Yahoo also may have a greater ability to attract and retain users than we do because they operate Internet portals with a broad range of content products and services. If Microsoft or Yahoo are successful in providing similar or better web search results compared to ours or leverage their platforms to make their web search services easier to access than ours, we could experience a significant decline in user traffic. Any such decline in traffic could negatively affect our revenues." See Amendment No. 5 to Google Inc. Form S-1 (SEC File No. 333-117934), filed with the SEC on November 23, 2004.

10. See comments #30 through #38.

11. For further information regarding use of plain English in SEC disclosure documents, see "A Plain English Handbook—How to create clear SEC disclosure documents," available at <http://www.sec.gov/pdf/handbook.pdf>.

12. See Securities Act Release No. 33-7497 (January 28, 1998).

13. See Division of Corporation Finance: Updated Staff Legal Bulletin No. 7, "Plain English Disclosure," Q&A #11, dated June 7, 1999. The SEC also notes: "You will likely reduce the length of your plain English prospectus by writing concisely and eliminating redundancies—not by eliminating substance."

14. The SEC has attempted to limit the use of endless pages of risk factors to hide important risks among meaningless ones. In the book *Monkey Business* by John Rolfe and Peter Troob, two former Wall Street investment bankers with Donaldson, Lufkin & Jenrette, Rolfe and Troob describe risk factors in the following way: "Years ago, the banker, the lawyers, and the company all used to spend a lot of time fighting about what went into . . . [the risk factors]. The bankers and the company didn't want to put too much in here, because they thought that people might get scared and not buy into the offering. The lawyers, though, . . . just wanted to cover their asses. The fights raged on and on. Then, one day, folklore has it, a brilliant young lawyer came up with a most Machiavellian strategy. He decided that if he overloaded this section with a bunch of irrelevant drivel, people would give up in frustration and neglect to read any of it or, at the very least, stand a good chance of missing the really important points. The strategy was pure genius. Today, there may be one or two risk factors that are relevant, really relevant, for any given deal. The rest is window dressing, but there's so much of this extraneous window dressing that the relevant risk factors get ignored." The SEC considered adopting changes to Regulation S-K to put limitations on the number of risk factors but declined to make such a change. See Securities Act Release No. 33-7497 (January 28, 1998).

15. Examples of boilerplate risk factors which could apply to almost any company in any line of business include warnings of potential harm to the company if: (1) sales decrease; (2) costs increase; (3) competition increases; or (4) the nation goes to war.

16. "Blanket warnings that securities involve a high degree of risk have been held insufficient to ward against a federal securities fraud claim." See *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994), quoting *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 858 (N.D. Cal. 1993). See also *In re Donald Trump Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993), in which the U.S. Court of Appeals for the Third Circuit stated: "[A] vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation."

17. Consider, for example, the following risk factor from the Form S-1 of the 1999 initial public offering of Martha Stewart Living Omnimedia, Inc. (which appeared as the first risk factor). The risk factor states in part: "THE LOSS OF THE SERVICES OF MARTHA STEWART OR OTHER KEY EMPLOYEES WOULD MATERIALLY ADVERSELY AFFECT OUR REVENUES, RESULTS OF OPERATIONS AND PROSPECTS. We are highly dependent upon our founder, Chairman and Chief Executive Officer, Martha Stewart. Martha Stewart's talents, efforts, personality and leadership

have been, and continue to be, critical to our success. The diminution or loss of the services of Martha Stewart, and any negative market or industry perception arising from that diminution or loss, would have a material adverse effect on our business. While our other key executives have substantial experience and have made significant contributions to our business, Martha Stewart remains the personification of our brands as well as our senior executive and primary creative force . . ." See Martha Stewart Living Omnimedia, Inc. Form S-1 (SEC File No. 333-84001), filed with the SEC on October 18, 1999. While the risk factor warns of the consequences of the loss of Martha Stewart to the business, the adequacy of the risk factor can be judged only on the basis of additional information. At the time the risk factor was drafted, the company presumably had no reason to fear that Martha Stewart would be indicted or convicted. This same risk factor, if it had been drafted at a time when Martha Stewart faced specific risks of indictment, would not have been adequate, as it would have been overly generic, and would have failed to describe specifically the principal risk facing the company.

18. "[T]he bespeaks caution doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. By contrast, blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim." See *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994), quoting *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 858 (N.D. Cal. 1993).

19. See *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991).

20. The SEC noted in Release No. 33-8501 that some issuers include risk factor disclosure in Exchange Act reports, even though they were not required to do so, "to take advantage of the safe harbor for forward-looking statements in Securities Act Section 27A and the bespeaks caution defense developed through case law." See footnote 374 to Release No. 33-8501 (November 17, 2004).

21. *In re Donald Trump Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993).

22. The Third Circuit noted: "The prospectus explicitly stressed the severity of competition the Taj Mahal would face. . . . [T]he prospectus specified with particularity the number of casinos in Atlantic City which would compete with the Taj Mahal. . . . It warned that "the Partnership believes that, based upon historical trends, casino win per square foot of casino space will decline in 1990 as a result of a projected increase in casino floor space, including the opening of the Taj Mahal." The prospectus . . . stated flatly: "Growth in Atlantic City casino win is expected to be restrained . . . . No assurance can be given with respect to either the future growth of the Atlantic City gaming market or the ability of the Taj Mahal to attract a representative share of that market." Furthermore, the prospectus underscored that the Taj Mahal would compete with other Trump-owned casinos in Atlantic City. . . . In short, the prospectus extensively and graphically disclosed the magnitude of the competition that the Taj Mahal would face."

23. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for certain forward-looking statements. In general, forward-looking statements fall within the safe harbor so long as they are identified as forward-looking statements and are accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." See Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, for the specific laws with respect to this safe harbor.

24. Item 303 of Regulation S-K requires disclosure of forward-looking information in Exchange Act Reports regarding currently known trends, events or uncertainties which are likely to have a material impact on liquidity, capital resources and results of operations.

25. Microsoft discloses risks relating to challenges to its business model, intellectual property rights risks, risks related to new products and services

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and litigation risks. The Goldman Sachs Group, Inc.'s annual report on Form 10-K for the fiscal year ended November 26, 2004, also has similar disclosure, with a section entitled "Cautionary Statement Pursuant to The Private Securities Litigation Reform Act of 1995" which references another part of the Form 10-K containing factors that could cause actual results to differ, possibly materially, from the results indicated in the forward-looking statements.

26. Even though Form 20-F, Item 3.D., states: "Companies are encouraged, but not required, to list the risk factors in the order of their priority to the company" and the SEC declined to revise Regulation S-K to require prioritization of risk factors (*See* Securities Act Release No. 33-7497 (January 28, 1998)), it is best practice to prioritize risk factors in order of importance so that investors or shareholders can understand which risks are the most serious ones facing the company.

27. After the September 11, 2001, terrorism incidents which killed thou-

sands of people and destroyed or disrupted the business of many companies, some companies began to consider the possible negative consequences to their companies of terrorist activities or other catastrophic events. While companies with major facilities in earthquake zones or in areas susceptible to severe weather conditions or other natural disasters had already been in the practice of warning investors of the possible adverse affects of such events, the terrorism of 9/11 caused many other companies to warn of the possible negative consequences to their businesses as a result of acts of terrorism or natural disasters. While this disclosure was reasonable for companies that were particularly exposed to the consequences of terrorist acts, such as travel and leisure companies, for many other companies this type of risk factor was no more than boilerplate disclosure — unobjectionable, except to the extent that the volume of boilerplate disclosure obscured the more relevant risks.

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