

The “Reasonable Investor” of Federal Securities Law: Insights from Tort Law’s “Reasonable Person” & Suggested Reforms

Amanda M. Rose*

Federal securities law defines the materiality of corporate disclosures by reference to the views of a hypothetical “reasonable investor.” For decades the reasonable investor standard has been a flashpoint for debate—with critics complaining of the uncertainty it generates and defenders warning of the under-inclusiveness of bright-line alternatives. This Article attempts to shed fresh light on the issue by considering how the reasonable investor differs from its common law antecedent, the reasonable person of tort law. The differences identified suggest that the reasonable investor standard is more costly than tort law’s reasonable person standard—the uncertainty it generates is both greater and more pernicious. But the analysis also reveals promising ways to mitigate these costs while retaining the benefits of the flexible standard.

I. INTRODUCTION	77
II. THE REASONABLE PERSON.....	82
III. THE REASONABLE INVESTOR	86
A. Who is the Reasonable Investor?	88
B. The Role of Context	92
C. Companies’ Plea for Bright-Line Rules	93
D. The Impact of the PSLRA	99
IV. THE REASONABLE INVESTOR VS. THE REASONABLE PERSON.....	101
V. IMPLICATIONS FOR REFORM.....	108
A. Identify the Reasonable Investor	109
B. Create an Early, But Evidence-Based, Decision Point	112
VI. CONCLUSION.....	117

I. INTRODUCTION

Securities class actions have been called the “800-pound gorilla that dominates and

* Professor of Law, Vanderbilt University Law School. For helpful comments on earlier drafts, I would like to thank participants at the 18th Annual Law & Business Conference at Vanderbilt University Law School as well as participants at workshops held at Northwestern University Law School, William & Mary Law School, and Brooklyn Law School. All errors and omissions are my own.

overshadows other forms of class actions” in the United States and for good reason.¹ They constitute nearly half of all class actions filed in the federal courts,² claim a disproportionate amount of judicial time and attention due to their procedural complexity,³ and are responsible for the “vast majority of the money involved in class action settlements”—averaging over \$5 billion annually for the past ten years, based on data compiled by Cornerstone Research.⁵

To say securities class actions have been controversial is an understatement. For decades public companies have argued that the enormous damage awards they threaten renders settlement of even low-merit cases rational, promoting the filing of frivolous suits.⁶ This argument convinced Congress to enact, over the veto of President Clinton, the Private Securities Litigation Reform Act of 1995 (PSLRA).⁷ The PSLRA includes a variety of measures designed to deter the filing of weak cases.⁸ Most importantly, the PSLRA heightened the standard for pleading scienter in securities fraud cases brought under SEC Rule 10b-5, while simultaneously denying plaintiffs the right to discovery until after resolution of a motion to dismiss.⁹ The PSLRA did not, however, heighten the pleading requirement for materiality, a notoriously vague element of plaintiffs’ *prima facie* case under not only Rule 10b-5,¹⁰ but also Section 11 of the Securities Act of 1933,¹¹ and which serves to define the scope of public companies’ disclosure obligations more generally.¹² Today, materiality is the main fodder for merit-based critiques of securities class actions.

Materiality’s vagueness stems from its definition: material information is information that a “reasonable investor” would consider important.¹³ The “reasonable investor” is at best a shadowy figure, described only generically in judicial opinions and—in doctrine if not in practice—someone for the fact-finder to identify case-by-case.¹⁴ Public companies have long bemoaned the reasonable investor test, arguing that materiality should be judged

1. John C. Coffee Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006).

2. *Id.*

3. *Id.* at 1540.

4. Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. EMPIRICAL LEGAL STUD. 811, 825 (2010) (emphasis omitted).

5. See Laarni T. Bulan et al., *Securities Class Action Settlements: 2015 Review and Analysis*, CORNERSTONE RES. 3 (2015), <http://securities.stanford.edu/research-reports/1996-2015/Settlements-Through-12-2015-Review.pdf>.

6. See, e.g., Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1469, 1477–98 (2004) (outlining this argument and surveying empirical studies speaking to its validity).

7. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 (1995), 15 U.S.C. § 78u-4 (2012).

8. See Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1319 (2008) [hereinafter *Reforming Securities Litigation Reform*] (summarizing measures to deter the filing of weak cases).

9. 15 U.S.C. §§ 78u-4(b)(2), (b)(3)(B) (2012).

10. 17 C.F.R. § 240.10b-5 (2017) (rendering it unlawful to “make any untrue statement of a *material* fact or to omit to state a *material* fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,” “in connection with the purchase or sale of any security”) (emphasis added).

11. 15 U.S.C. § 77k (2017) (creating a private cause of action against specified defendants for any “untrue statement of a *material* fact” contained in a registration statement, or “[omission of] a *material* fact required to be stated therein or necessary to make the statements therein not misleading”) (emphasis added).

12. See *infra* notes 56–57 and accompanying text.

13. TSC Industries v. Northway, 426 U.S. 438, 445 (1976).

14. See *infra* Part III.A.

instead by reference to quantitative or other bright-line measures, so as to simplify companies’ disclosure choices and provide a basis for dismissal of securities litigation at the pleadings or summary judgment phase.¹⁵

Neither the SEC nor the Supreme Court has been receptive to companies’ pleas. To the contrary, in 1999 the SEC released a Staff Accounting Bulletin flatly rejecting their preferred quantitative approach to materiality.¹⁶ And the Supreme Court has repeatedly rejected other bright-line tests advocated by defendants, fearing such tests would create a roadmap for fraud.¹⁷ Far from jettisoning it altogether, as companies would prefer, the Supreme Court recently reaffirmed the reasonable investor’s role in securities litigation, holding in *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund* that whether an omission of a material fact renders a statement made misleading must, like the materiality determination itself, be judged from the reasonable investor’s perspective.¹⁸

The lower courts have proven more sympathetic to company concerns, adopting a variety of “immaterial as a matter of law” doctrines that allow for pretrial dismissal of securities class actions.¹⁹ These doctrines have been berated by scholars and plaintiffs’ lawyers alike. Not only do they permit decisions based on little more than judicial hunches about “reasonable investor” behavior, the argument goes, but they also conflict with Supreme Court precedent teaching that materiality determinations are highly fact-intensive and thus should rarely be made before trial.²⁰

The persistent disagreement surrounding the reasonable investor test is hardly surprising. The dispute has always been framed in terms of the perennial “rules versus standards” debate—with critics of the reasonable investor test complaining of the uncertainty the test generates and defenders warning of the under-inclusiveness of the bright-line rules offered as alternatives. Such debates tend to prove intractable: an accounting of the tradeoffs occasioned by the choice between rules and standards rarely reveals a clear victor.²¹

This Article approaches the issue in a different way. The point of departure is the observation that the “reasonable investor” is not without kin in the law. To the contrary, the reasonable investor has a well-known legal antecedent: tort law’s storied “reasonable person.” The reasonable investor standard shares the same basic justification as tort law’s reasonable person standard: whether information is important or misleading requires an objective but at the same time highly contextualized analysis, making it difficult to craft ex ante rules on point that are not grossly over- or under-inclusive. Since the earliest uses of the reasonable person standard, defendants have complained about the uncertainty that surrounds its application, and the room this leaves for inconsistent and even biased decision-making. But the perseverance of tort law’s reasonable person standard over the course of centuries of common law development suggests that its benefits likely outweigh its costs. This raises the question: does the reasonable investor standard differ from tort law’s reasonable person standard in ways that suggest it is less efficient?

15. See *infra* Part III.C.

16. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 12, 1999), <https://www.sec.gov/interp/account/sab99.htm> [hereinafter SAB 99].

17. See *infra* Part III.C.

18. *Omnicare Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1322 (2015).

19. See *infra* notes 119–20 and accompanying text.

20. See *infra* notes 128–133 and accompanying text.

21. See *infra* notes 153–160 and accompanying text.

The question is a natural one to ask. In interpreting the liability provisions of the federal securities laws, the Supreme Court regularly seeks to bolster its decisions by drawing analogies or distinctions between modern securities litigation and the common law tort of misrepresentation.²² Scholars, too, have long engaged in such analysis.²³ Yet the relationship between the reasonable investor standard and tort law's reasonable person standard remains unexplored.

A comparison of the two standards reveals at least three notable differences. The first concerns the need for expert testimony in a securities case and the concomitant decreased importance of the jury. In a simple tort case the indeterminacy of the reasonable person standard is mitigated by the use of the jury, which can channel its collective wisdom as to what constitutes reasonable behavior in deciding the outcome of the case.²⁴ Indeed, the jury is viewed as uniquely competent to perform this task; assigning such work to a single judge would present legitimacy problems that jury resolution avoids. When a case involves a specialized activity like securities investing, by contrast, a lay jury is unlikely to have any collective wisdom to offer; rather, expert testimony should be utilized to educate the fact-finder. Judges are arguably better positioned than juries to evaluate expert evidence, or at least as well positioned.²⁵

The second important difference flows from the first: whereas it is tolerable and even desirable to leave the identity of the "reasonable person" vague in a simple tort case, because the jury can be trusted to imbue the concept with an accepted social meaning, the same cannot be said about the identity of the "reasonable investor." Whether, for example, the reasonable investor is a retail investor or a market professional is not a choice that should be made by juries on a case-by-case basis. Nor, for that matter, should they be made by unaccountable judges. Rather, the identity of the reasonable investor is a policy choice that should be made by the SEC in rulemaking or by Congress in legislation, so that companies understand how to think about their disclosure obligations and experts in securities cases understand just what it is they should opine on.

Tort cases alleging professional negligence provide a good analogue. The common law does not ask juries in such cases to provide normative content to the standard of care, and to apply that standard based on social intuition. The reason is obvious: a lay jury would be wholly unsuited to those tasks. Instead, the standard of care is defined by law as the care that would be taken by a reasonable professional in the same field as the defendant, and the jury is required to apply that standard based solely on the expert testimony received.²⁶

The reasonable investor standard differs from the reasonable person standard in

22. See, e.g., *Omnicare*, 135 S. Ct. at 1330–31; *id.* at 1334–37 (Scalia, J., dissenting); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 171–73 (2008) (Stevens, J., dissenting); *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343–45 (2005); *Basic Inc. v. Levinson*, 485 U.S. 224, 243–45 (1988); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388–89 (1983); *Chiarella v. United States*, 445 U.S. 222, 247 (1980) (Blackmun, J., dissenting); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744–49 (1975).

23. See, e.g., Merritt B. Fox, *After Dura: Causation in Fraud-on-the-Market Actions*, 31 J. CORP. L. 829 (2006); Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985); Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984); Douglas M. Branson, *Statutory Securities Fraud in the Post-Hochfelder Era: The Continued Viability of Modes of Flexible Analysis*, 52 TUL. L. REV. 50 (1977).

24. See *infra* notes 45–47 and accompanying text.

25. See *infra* note 49 and accompanying text.

26. See *infra* note 48 and accompanying text.

another important way. Federal securities law doctrines, foreign to the common law tort of misrepresentation, have expanded the universe of investors who can sue and have facilitated the aggregation of their claims.²⁷ As a result, the stakes in federal securities fraud cases are dramatically higher than at common law. The uncertainty generated by the reasonable investor standard therefore creates a stronger pressure to settle cases that are not dismissed pretrial than does the uncertainty generated by the reasonable person standard in traditional tort cases. It also creates a stronger pressure for potential defendants to distort their behavior in socially undesirable ways in order to avoid litigation. In the securities context, such distortion manifests when companies fail to disclose information that may be helpful to investors, out of a fear it will be deemed misleading, or burden investors with trivial information, out of a fear that its omission will give rise to liability.

The distinctions identified indicate that use of the reasonable investor standard is, in all likelihood, more costly than the prototypical use of the reasonable person standard in tort. They do not, however, support abandoning the reasonable investor standard in favor of bright-line rules, as critics have long advocated. Such a move would create loop-holes that could be exploited to defraud investors, and the net effects of this tradeoff are impossible to measure or predict. The distinctions do, however, suggest a package of reforms capable of producing more certain social welfare gains.

The first reform that flows from the analysis has already been alluded to: the identity of the reasonable investor should be elucidated through SEC rulemaking or federal statute.²⁸ Unlike in a simple tort case, there is no justification for leaving the standard of care ambiguous when it comes to corporate disclosure obligations. Rather, as in professional negligence cases, the standard should be defined by law. Specifying the reasonable investor’s identity may be politically uncomfortable for the responsible policymakers, but it would not undermine the flexibility of the reasonable investor standard: experts and fact-finders would still be called upon to consider all of the facts and circumstances of a particular case in deciding how a reasonable investor would have reacted to challenged information, they would just do so through a more carefully articulated lens.

The second reform proposal is both bolder and more contestable. The analysis suggests that a mechanism should be developed that would allow judges to apply the reasonable investor test before trial, but with the benefit of evidence.²⁹ Swayed by companies’ complaints about the intense pressure they face to settle, district courts today often do apply the reasonable investor test to dismiss securities class actions pretrial. But they do so using judge-made “immaterial as a matter of law” doctrines that are applied without the benefit of expert testimony. Creating a procedural mechanism that allows judges to consider such testimony in applying the reasonable investor test would result in more principled decision-making.

To be sure, the effect of this approach would be to formally take the issue away from the jury and place it in the hands of the judge, at least preliminarily. But unlike in a simple tort case, there is no compelling policy reason for reserving this issue to the jury in the first place. Moreover, the reality is that the jury will never decide the issue anyway: if the case

27. See *infra* text accompanying note 182.

28. See *infra* Part V.A.

29. See *infra* Part V.B.

is not disposed of by the court pretrial, it almost inevitably will settle.³⁰ This, of course, is the concern that has led district courts to adopt the “immaterial as a matter of law” doctrines in the first place.

What form should the mechanism take? This Article argues that the most promising approach would be for Congress to adopt a statute tying class certification of securities claims to proof of a material misstatement, omission, or misleading half-truth. Granting courts the authority to apply the reasonable investor standard at the class certification stage would diffuse any unfair settlement pressure that the standard produces when left for resolution at a class trial, and would foster the development of precedent—much the way the “immaterial as a matter of law” doctrines do today. Unlike judges applying those doctrines, however, judges applying the reasonable investor standard pursuant to the proposed statute would do so lawfully, and with the benefit of critically needed expert evidence.

The remainder of this Article proceeds as follows. Part II discusses the well-recognized advantages and disadvantages of tort law’s reasonable person standard. Part III explains the role that the reasonable investor standard plays under the federal securities laws and lays out the longstanding critiques leveled against the standard by both market participants and securities law scholars. Part IV analyzes some of the ways in which the reasonable investor standard differs from the reasonable person standard of the common law. The reform implications of these differences are then addressed in Part V, and potential objections and alternatives discussed. Part VI briefly concludes.

II. THE REASONABLE PERSON

In a wide variety of settings, the law asks fact-finders to imagine the behavior of a hypothetical reasonable person in order to determine whether a litigant’s behavior comported with a particular legal requirement.³¹ This practice is most famously associated with the common law of tort. As every first-year law student learns, whether a defendant has acted negligently depends on whether a reasonable person in like circumstances would have taken more care.³² Whether a matter is material for purposes of the common law tort of misrepresentation similarly depends on whether a reasonable person would have attached importance to it in determining his choice of action in the transaction in

30. According to NERA, out of the nearly 5,000 securities class actions filed since the PSLRA was enacted in 1995, only 21 (0.4%) have gone to trial and only 16 (0.3%) have been tried to completion. See Stefan Boettrich & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2016 Full-Year Review*, NERA ECON. CONSULTING 41 (2017), http://www.nera.com/content/dam/nera/publications/2017/PUB_2016_Securities_Year-End_Trends_Report_0117.pdf; see also *Securities Class Action Filings: 2017 Mid-Year Assessment*, CORNERSTONE RES. 20 (2017), <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2017-Midyear-Assessment> (reporting that of all securities class actions filed between 1997 and 2016, 10% are ongoing, 42% have been dismissed pretrial, 48% have settled, and less than 1% have reached a trial verdict).

31. See George P. Fletcher, *The Right and the Reasonable*, 98 HARV. L. REV. 949, 949 (1985) (observing that American attorneys “cannot even begin to argue about most issues of responsibility and liability without first asking what a hypothetical reasonable person would do under the circumstances”); Mayo Moran, *The Reasonable Person: A Conceptual Biography in Comparative Perspective*, 14 LEWIS & CLARK L. REV. 1233, 1234 (2010) [hereinafter Moran, *The Reasonable Person*] (observing that the reasonable person has “played a critical role in many different aspects of private law, criminal law, and recently has also extended his reach into the world of public law”).

32. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL AND EMOTIONAL HARM § 3 cmt. a (2010).

question.³³

Tort law’s use of the reasonable person standard has well-recognized benefits. Perhaps most famously, the court in *Vaughan v. Menlove* stressed the advantage of the reasonable person standard over one that would ask whether a litigant “acted bona fide to the best of his judgment.”³⁴ The court explained: “Instead . . . of saying that liability [] should be co-extensive with the judgment of each individual, which would be as variable as the length of the foot of each individual, we ought rather to adhere to the rule which requires in all cases a regard to caution such as a man of ordinary prudence would observe.”³⁵

In addition to eliminating difficult proof problems that would attend a subjective standard, thus aiding in administrability, the objective nature of the reasonable person standard has other advantages. Most notably, it has been applauded as creating desirable incentives, as the threat of liability may encourage individuals to push themselves to act as a reasonable person would. This, in turn, may allow the public to “more accurately gauge the level of self-protective care that they need to employ than would be possible if the amount of care that could be expected from others varied with the characteristics of each individual.”³⁶ Another benefit of the reasonable person standard is that it is, in fact, a standard—not a rigid rule—and thus can be applied with sensitivity to the myriad facts and circumstances which might influence the thoughts or behavior of a reasonable person in different situations.³⁷

Of course, the ease with which the standard can be applied, and the strength of its incentive effects, depends on how readily and consistently the fact-finder can channel the reasonable person. If the reasonable person standard is content-less, decisions applying it will be ad hoc and unprincipled, leaving us with something as variable as the subjective standard rejected in *Vaughan*. In light of this, it is not surprising that considerable efforts have been made to give flesh to the reasonable person. Perhaps most famously, Judge Learned Hand’s eponymous formula gives structure to the reasonable person’s decision-making process: A reasonable person is one who would forego taking some precaution only when the burden of that precaution (B) exceeds the harm that the precaution would avoid (L) multiplied by its probability (P); thus, negligence should be found if a defendant failed to take a precaution under circumstances where $B > PL$.³⁸

The Hand Formula, which is reflected today in Section 3 of the RESTATEMENT (THIRD) OF TORTS,³⁹ imbues the reasonable person with a particular (and contestable)

33. The common law tort of misrepresentation treats materiality as a component of justifiable reliance. RESTATEMENT (SECOND) OF TORTS § 538 (1977). For reliance to be justified, the matter misrepresented must be material. A matter is considered material if either a reasonable man would attach importance to it or if the “maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it.” *Id.*

34. *Vaughan v. Menlove* (1837), 132 Eng. Rep. 490, 493. The reasonable person standard incorporates characteristics of the particular defendant in special cases, such as those involving children and the infirm. See KENNETH S. ABRAHAM, THE FORMS AND FUNCTIONS OF TORT LAW 57–60 (3d ed. 2007).

35. *Vaughan*, 132 Eng. Rep. at 493.

36. ABRAHAM, *supra* note 34, at 56.

37. But see generally Christopher Jackson, *Reasonable Persons, Reasonable Circumstances*, 50 SAN DIEGO L. REV. 651 (2013) (problematising traditional selection of circumstances that are considered in applying the reasonable person test).

38. See United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947).

39. See *supra* note 32.

normative perspective: a reasonable person should make decisions according to a utilitarian cost-benefit analysis with the ultimate goal of maximizing social welfare.⁴⁰ Competing normative visions of the reasonable person exist, including most prominently a Kantian vision of the reasonable person premised on notions of equal freedom,⁴¹ and alternatively, a feminist vision premised on an ethic of care.⁴²

While the relative strengths and limitations of these competing conceptions of the reasonable person are immensely interesting as a philosophical matter, one's view on these subjects is ultimately of little practical importance. This is so because jurors—who are typically tasked with applying the reasonable person standard—are rarely given detailed instructions on how they should go about doing so.⁴³ To the contrary, model jury instructions tend to be quite generic. For example, California's instruction on the basic standard of care in tort provides that a "person is negligent if he or she does something that a reasonably careful person would not do in the same situation or fails to do something that a reasonably careful person would do in the same situation"; as for what that means, the instructions unhelpfully inform jurors: "You must decide how a reasonably careful person would have acted in [name of plaintiff/defendant]'s situation."⁴⁴

And this, somewhat paradoxically, points to perhaps the strongest argument in *favor* of the reasonable person standard. Rather than specifying a more precise notion of socially appropriate behavior, which would be a politically difficult endeavor in a pluralistic society such as the United States,⁴⁵ the reasonable person standard relies on the collective wisdom of the jury as a proxy for the conscience of the community. As Prosser and Keeton explain it, the reasonable person is "a personification of a community ideal of reasonable behavior, determined by the jury's social judgment."⁴⁶ The important role that the jury plays in justifying the reasonable person standard was recognized in *Vaughan* itself. The court in that case dismissed the argument that the reasonable person standard was "too uncertain to afford any criterion" by invoking its faith in the jury: "The care taken by a prudent man has always been the rule laid down; and as to the supposed difficulty of applying it, a jury has always been able to say, whether, taking that rule as their guide, there has been

40. For a comprehensive overview of this perspective, see Alan D. Miller & Ronen Perry, *The Reasonable Person*, 87 N.Y.U. L. REV. 323, 328–48 (2012).

41. According to this perspective, "reasonable care ought to be the level of care that reconciles the conflicting liberties of injurers and victims: freedom of action (freedom to act and thereby impose risks) on the one hand, and security (freedom from accidental harm) on the other." *Id.* at 351. For a fulsome discussion of this view and its variants, see *id.* at 348–61.

42. For an introduction to this approach, see *id.* at 361–70.

43. See *id.* at 334 n.52 and authorities cited therein.

44. CIVIL JURY INSTRUCTIONS, CACI NO. 401 (JUDICIAL COUNCIL OF CALIFORNIA 2017), http://www.courts.ca.gov/partners/documents/CACI_2017_Edition.pdf.

45. See Fletcher, *supra* note 31, at 981 (explaining that a "pluralistic legal order mandates discretion," something the standard of reasonableness affords because it "invites consideration of diverse normative criteria in resolving the dispute").

46. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 175 (W. PAGE KEETON ed, 5th ed. 1984); see also Nancy S. Ehrenreich, *Pluralist Myths and Powerless Men: The Ideology of Reasonableness in Sexual Harassment Law*, 99 YALE L.J. 1177, 1192 (1990) ("Just as in negligence law, what constitutes reasonable behavior [under Title VII] is recognized to be a political question of where to draw the line between group and societal interests—that is, between diversity and conformity—and it is society, not the court, that makes that judgment. Thus, it is not so much that the reasonableness test is itself a neutral standard, but rather that it serves as a vehicle for importing an already-arrived-at (and legitimate) political solution into the law.").

negligence on the occasion in question.”⁴⁷ If instead a judge applied the reasonable person standard, he or she would be called upon to channel the “conscience of the community” alone, and the decision reached would be far less legitimate than one reached through the consensus of a group of diverse jurors.

This strength of the reasonable person standard is, however, subject to important qualifications. Most notably, in certain types of cases lay juries are poorly equipped to judge the reasonableness of conduct because they lack relevant personal experiences or background social norms upon which to draw. This is true in cases involving specialized activities, like the administration of medical care or other professional activities that require advanced training. There simply is no developed “conscious of the community” writ large to apply to the activities challenged in such cases. In this context, the common law replaces the reasonable person standard of a simple negligence case with a more precisely identified standard of care—one keyed to the behavior of a reasonable professional in the same field as the defendant—and instructs the jury to apply this standard based only on the expert testimony received.⁴⁸ The jury has no special advantage relative to the judge in evaluating expert evidence; to the contrary, many would argue that judges on average are better positioned to do so than lay jurors.⁴⁹

There are other bases for critiquing the reasonable person standard. The very vagueness that allows the standard to serve as a conduit for community norms also allows it to serve as a conduit for community prejudices.⁵⁰ This has led critical legal theorists to challenge the concept as fueling gender and racial biases.⁵¹ The vagueness of the standard similarly presents problems when fact finders are asked to judge behavior which fails to conjure a community consensus because it is novel, or because there are multiple legitimate paradigms of such behavior. In such cases, even unbiased fact-finders will reach divergent and unpredictable outcomes, undermining the incentive effects of the reasonable person

47. Vaughan v. Menlove (1837), 132 Eng. Rep 490, 493.

48. See, e.g., CIVIL JURY INSTRUCTIONS, CACI Nos. 501, 600.

49. See Douglas G. Smith, *Historical and Constitutional Contexts of Jury Reform*, 25 HOFSTRA L. REV. 377, 381 & n.4 (1996) (noting that the “jury has been characterized as an inferior and inefficient” institution for deciding complex issues, and collecting articles advancing this position). Indeed, the sentiment that judges are better equipped to handle complex cases than lay juries has led U.S. courts to flirt with the notion of a “complexity exception” to the Seventh Amendment (see, e.g., *In re Japanese Elec. Prod. Antitrust Litig.*, 631 F.2d 1069 (3rd Cir. 1980); *Bernstein v. Universal Pictures*, 79 F.R.D. 59 (S.D.N.Y. 1978); *In re Boise Cascade Sec. Litig.*, 420 F. Supp. 99 (W.D. Wash. 1976); but see *In re U. S. Fin. Sec. Litig.*, 609 F.2d 411 (9th Cir. 1979)), and has caused the United Kingdom to abandon the civil jury almost entirely (see Sally Lloyd-Bostock & Cheryl Thomas, *The Continuing Decline of the English Jury*, in *WORLD JURY SYSTEMS* (Neil Vidmar ed., 2000)).

50. See, e.g., MAYO MORAN, *RETHINKING THE REASONABLE PERSON: AN EGALITARIAN RECONSTRUCTION OF THE OBJECTIVE STANDARD* 13 (2003) (“the reasonable person may act as an invitation to draw on underlying stereotypes that are often played out through unreflective ideas of what is normal or ordinary”).

51. See Moran, *The Reasonable Person*, *supra* note 31, at 1236 (explaining that “concerns about the nature and use of the discretion implicit in the reasonable person test began to take on a sharper edge as feminists and other equality seekers turned their attention to the way that reliance on the reasonable person tends to reinforce the privilege of the powerful while simultaneously exacerbating the plight of those who are disadvantaged”); see also *id.* at 1249–59 (explaining how gendered conceptions of the reasonable person may have led to biased applications of the defenses of provocation and self-defense in criminal cases); Ehrenreich, *supra* note 46, at 1230 (arguing that “both reasonableness and pluralism are problematic concepts which hide the power struggles behind legal issues and mystify the courts’ role in resolving such struggles”).

standard.⁵²

Finally, to the extent that the Hand Formula does guide fact-finders' understanding of the reasonable person standard, it invites not only the normative objections alluded to above, but also raises empirical concerns. A substantial body of research on human behavior suggests that individuals do not typically behave as the rational actor envisioned by classical economists.⁵³ To the contrary, individuals suffer from a battery of cognitive biases that, among other things, interfere with their ability to properly assess probabilities.⁵⁴ This is clearly problematic if one believes that the reasonable person should descriptively capture the "ordinary" person. It is less problematic if one views the reasonable person as setting an aspirational standard of behavior, and the risk of legal liability creates incentives for individuals to overcome their cognitive biases in order to conform to it.

III. THE REASONABLE INVESTOR

For better or for worse, the federal securities laws place heavy reliance on a variant of the reasonable person standard—the so-called "reasonable investor" standard. Most importantly, the reasonable investor standard informs the concept of materiality,⁵⁵ which in turn defines the scope of companies' disclosure obligations. For example, Regulations S-K and S-X, which govern the narrative and financial content of registration statements and periodic reports, limit many of their disclosure requirements to "material" information.⁵⁶ Moreover, Rule 408, under the Securities Act of 1933, and Rule 12b-20, under the Securities & Exchange Act of 1934, require companies to disclose, in addition to the information expressly required to be included in SEC filings, "such further *material* information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."⁵⁷ The liability provisions in the federal securities laws are similarly limited to misstatements of *material* fact, or the omission of *material* facts necessary to render statements made not misleading.⁵⁸ In addition, Regulation FD prohibits companies from selectively disclosing *material* corporate information to certain market participants,⁵⁹ and corporate insiders are forbidden to trade in their companies' stock for personal benefit when in possession of *material* nonpublic information.⁶⁰

The Supreme Court first adopted the reasonable investor test for materiality in *TSC*

52. Moreover, in some situations we may prefer that the decision maker be explicit about the choices driving the legal conclusion reached. See, e.g., Susan F. Mandiberg, *Reasonable Officers vs. Reasonable Lay Persons in the Supreme Court's Miranda and Fourth Amendment Cases*, 14 LEWIS & CLARK L. REV. 1481, 1536 (2010) ("By using the metaphor of the 'reasonable person' . . . the Court avoids a forthright assessment of the factors it balances in deciding the constitutional limits on government investigative powers. Such an approach . . . hampers the ability of citizens and their elected representatives to determine whether to buttress those rights through legislation or state constitutions.").

53. For an introduction to this body of research, see generally Robert A. Prentice, *Chicago Man, K-T Man, and the Future of Behavioral Law and Economics*, 56 VAND. L. REV. 1663 (2003).

54. See Miller & Perry, *supra* note 40, at 341–42 and authorities cited therein.

55. See *infra* note 61 and accompanying text.

56. See, e.g., 17 C.F.R. § 229.303(a)(1) (2017); 17 C.F.R. § 210.2-02(c)(2) (2005).

57. 17 C.F.R. §§ 230.408, 240.12b-20 (2005) (emphasis added).

58. See, e.g., *supra* notes 10–11.

59. 17 C.F.R. § 243.100(a).

60. *Dirks v. SEC*, 463 U.S. 646, 654 (1983).

Indus. v. Northway, a shareholder suit brought under SEC Rule 14a-9 alleging that the defendant’s proxy statement omitted material facts required to be stated therein.⁶¹ The Court explained that the question of materiality

... is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor An omitted fact is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote. . . . 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.⁶²

Subsequently, in *Basic v. Levinson*, the Court “expressly adopt[ed] the *TSC Industries* standard of materiality” as the general standard for materiality under § 10(b) and Rule 10b-5,⁶³ and similar formulations have also been incorporated into SEC rules⁶⁴ and accounting guidance issued by the Financial Accounting Standards Board (FASB).⁶⁵

In addition to defining the concept of materiality, the reasonable investor also plays a role in defining the concept of “misleadingness” under the liability provisions of the federal securities laws. Plaintiffs in securities class actions often claim that a challenged statement

61. *TSC Indus. v. Northway*, 426 U.S. 438 (1976). Before the Supreme Court weighed in on the meaning of the materiality concept, “the SEC defined the term by focusing on ‘those matters as to which an average prudent investor ought reasonably to be informed.’” James D. Redwood, *Qualitative Materiality Under the SEC Proxy Rules and the Fifth Amendment: A Disclosure Accident Waiting to Happen or Two Ships Passing in the Night?*, 1992 Wisc. L. REV. 315, 332 (1992).

62. *TSC Indus.*, 426 U.S. at 445, 449. The *TSC* court departed somewhat from the conventional tort test of materiality by requiring that there be a “substantial likelihood” a reasonable investor would consider the information important. *See supra* note 33.

63. *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).

64. SEC Rule 405, promulgated under the Securities Act of 1933, provides that “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 purchase the security registered.” 17 C.F.R. § 230.405 (2017). SEC Rule 12(b)(2), promulgated under the Securities & Exchange Act of 1934, similarly provides: “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.” 17 C.F.R. § 240.12b-2 (1994). *See also* Yvonne Ching Ling Lee, *The Elusive Concept of “Materiality” Under U.S. Federal Securities Laws*, 40 WILLAMETTE L. REV. 661, 662–63 (2004) (observing that the *TSC* standard “has been judicially applied to insider trading and administratively applied to selective disclosure under Regulation FD”).

65. *See Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information*, FASB (1980), www.fasb.org/cs/blobserver?blobcol=urldata&blobtable=mungoblobs&blobkey=id&blobwhere=1175820900526&blobheader=application%2Fpdf (defining materiality). FASB recently proposed to amend the FASB Accounting Standards Codification so that it identifies materiality as a legal concept. *See ACS Notes to Financial Statements*, DELOITTE (Sept. 24 2015), <http://www.iasplus.com/en-us/standards/fasb/presentation/asc235> (explaining FASB Accounting Standards Codification Topic 235); *Proposed Accounting Standard Update*, FASB (Sept. 24, 2015), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166402325&acceptedDisclaimer=true [hereinafter *Proposed ASU*]. *See also* Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 320–21 (2007) (“The Commission has repeatedly acknowledged the *TSC Industries* standard as controlling in the agency’s regulatory initiatives and enforcement actions. It also informs the professional standards applied to public company auditors.”).

was not, in and of itself, a misstatement, but rather was rendered misleading (and therefore actionable) by the omission of other material information necessary to put the statement in context—a so-called “half-truth” theory of liability.⁶⁶ The recent Supreme Court case *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund* involved such a theory.⁶⁷ Plaintiffs challenged certain opinions expressed in the defendant’s registration statement related to its legal compliance.⁶⁸ As is common in Section 11 cases, the plaintiffs omitted any allegations of scienter so as to avoid heightened pleading under Federal Rule of Civil Procedure 9(b),⁶⁹ thus conceding that the opinions were genuinely held.⁷⁰ In light of this, the Court held that the opinions themselves could not be deemed misstatements of fact, even if objectively unreasonable,⁷¹ but explained that they might nevertheless be actionable if rendered misleading by the omission of other information. The Court declared that “whether a statement is ‘misleading’ depends on the perspective of a reasonable investor: The inquiry (like the one into materiality) is objective.”⁷² The Court elaborated:

[A] reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker’s basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience. . . . Thus, if a registration statement omits material facts about the issuer’s inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11’s omissions clause creates liability.⁷³

The question of what information a reasonable investor would understand a statement to convey, like the question of what information a reasonable investor would consider important, turns on two key factors: (1) just *who* the reasonable investor is and (2) the factual context. Both factors are discussed below.

A. Who is the Reasonable Investor?

Notwithstanding the important role the reasonable investor plays in federal securities regulation, “courts have not spoken with one clear voice on its identity,” leaving the figure “anonymous, elusive, and the subject of much inquiry.”⁷⁴ The snippets of judicial guidance

66. See Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences By Investors and Others*, 52 STAN. L. REV. 87, 90–91 (1999) [hereinafter Langevoort, *Half-Truths*].

67. *Omnicare, Inc., v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1318 (2015).

68. *Id.* at 1323–24.

69. Scienter is not an element of a Section 11 claim. Therefore, the heightened pleading called for under Federal Rule of Civil Procedure 9(b) for allegations of fraud is triggered in a Section 11 case only if the plaintiffs voluntarily plead facts that “sound in fraud.” See Marc I. Steinberg & Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism*, 63 RUTGERS U. L. REV. 1, 38–39 (2010).

70. *Omnicare*, 135 S. Ct. at 1327.

71. *Id.* (“a sincere statement of pure opinion is not an ‘untrue statement of material fact’, regardless whether an investor can ultimately prove the belief wrong”).

72. *Id.*

73. *Id.* at 1328–29.

74. Tom C.W. Lin, *The New Investor*, 60 UCLA L. REV. 679, 694–95 (2013) [hereinafter Lin, *The New Investor*]. See also Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA.

on the reasonable investor’s characteristics that do exist lead most scholars to envision a rational actor, possessing a basic level of financial sophistication.⁷⁵ Case law instructs that “the reasonable investor grasps market fundamentals—for example, the time value of money, the peril of trusting assumptions, and the potential for unpredictable difficulties to derail new products.”⁷⁶ In addition, the “Supreme Court tells us that courts should not treat reasonable investors like ‘nitwits’ and ascribe to them ‘child-like simplicity,’” and “courts have stated disclosure should not be tailored to ‘what is fit for rubes.’”⁷⁷ Moreover, certain materiality doctrines which have developed in the lower courts (discussed *infra*⁷⁸) assume that reasonable investors: discount sales talk; if given certain pieces of information, can and will perform mathematical calculations to determine the bottom line; and consider the context surrounding a statement in determining its import.⁷⁹ Reasonable investors are not, however, expected to possess skills rising to the level of a trained investment analyst.⁸⁰

This conception of the reasonable investor as a rational but nonprofessional participant in the capital markets, though consistent with what Professor Langevoort has

J. BUS. & EMPL. L. 339, 344 (2008) [hereinafter Padfield, *Is Puffery Material*] (“There are differing notions as to who exactly this reasonable investor is for purposes of materiality determinations under the securities laws. Some argue that the reasonable investor for purposes of assessing materiality is ‘a savvy person who grasps market fundamentals.’ . . . However, courts have not spoken in one voice on this point . . .”); Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 293 (2009) (“The conception of the reasonable investor . . . is at best fluid and at worst ill-defined. The descriptive and normative attributes of the reasonable investor are critically important to the development of securities fraud law and regulation, yet they are under-analyzed.”).

75. See, e.g., Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. Rev. 461, 466–67 (2015) (observing that “[i]n the many decades since the birth of the modern financial regulatory framework, regulators, scholars, and courts have not universally agreed upon the identity and defining characteristics of the reasonable investor,” but that the “leading paradigm” views the reasonable investor as “the idealized, perfectly rational actor of neoclassical economics”); David A. Hoffman, *The “Duty” To Be A Rational Shareholder*, 90 MINN. L. REV. 537, 542 (2006) [hereinafter Hoffman, “Duty” To Be A Rational Shareholder] (“This Article finds evidence that courts implicitly equal investors’ ‘reasonableness’ with economic rationality, and irrationality as unreasonableness.”); Heminway, *supra* note 74, at 297 (“Decisional law and the related literature support the view that the reasonable investor is a rational investor (although judicial decisions are careful not to make this linkage explicit.”); Barbara Black, *Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets*, 44 LOY. U. CHI. L. REV. 1493, 1495 (2013) (“courts hold investors to a high standard of rationality”); Langevoort, *Half-Truths*, *supra* note 66 at 105 (noting that most courts “assume that the ‘listener’ with respect to corporate publicity is the sophisticated, informed investor”); cf. Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 385 (1984) (describing cases adopting an expansive definition of the reasonable investor so as to protect unsophisticated as well as sophisticated investors); Stefan J. Padfield, *Immaterial Lies: Condoning Deceit in the Name of Securities Regulation*, 61 CASE W. RES. L. REV. 143, 155 (2010) [hereinafter Padfield, *Immaterial Lies*] (“It seems clear, as far as the SEC is concerned, that the reasonable investor, for purposes of materiality determinations, is the unsophisticated retail investor”).

76. Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing “the Reasonable Investor” with “the Least Sophisticated Investor” in Inefficient Markets*, 81 TUL. L. REV. 473, 475–79 (2006) (citing Levitin v. PaineWebber, Inc., 159 F.3d 698, 702 (2d Cir. 1998); Harris v. Ivax Corp., 182 F.3d 799, 807 (11th Cir. 1999); Hillson Partners Ltd. P’ship v. Adage, Inc., 42 F.3d 204, 213 & n.7 (4th Cir. 1994)).

77. Black, *supra* note 75 at 1494 (quoting *Basic*, 485 U.S. at 234, and Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987)).

78. See *infra* notes 119–122 and accompanying text.

79. Black, *supra* note 75, at 1494.

80. See Virginia Bankshares v. Sandberg, 501 U.S. 1083, 1097 (1991) (observing, in the proxy fraud context, that publishing accurate facts can negate the materiality of a false statement, but observing that “not every mixture of the true will neutralize the deception”; “[i]f it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow”).

referred to as the SEC's "myth story" of the earnest, rational retail investor,⁸¹ pleases few. In one camp are those who believe that the trained, professional investor, if not the market itself, should be considered the reasonable investor—not retail investors, however rational they are imagined to be.⁸² This argument can be cast in both descriptive and normative terms. Descriptively, the claim is that the vast majority of retail investors do not pay attention to, let alone rely on, corporate disclosures; rather, they are passive price-takers who rely on professional investors to seek out and trade on information and, by so doing, push prices to accurate levels.⁸³ Thus, the argument goes, the professional trader's vantage point is the appropriate one to take in considering the interpretation and importance of corporate disclosures.⁸⁴ This argument has particular force in secondary-market fraud cases brought pursuant to Rule 10b-5, because plaintiffs themselves concede it in order to avoid proving actual reliance: under the so-called fraud-on-the-market theory of reliance,⁸⁵ plaintiffs are presumed to have relied not on the challenged disclosure directly, but rather on the integrity of the implicated security's market price, which is itself presumed to have been distorted by the challenged disclosure through the trading activity of market professionals.⁸⁶ But the argument also has force in Section 11 cases, which involve registered public offerings; although prices in such offerings are not directly set by

81. Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. L. REV. 135, 173 (2002) [hereinafter Langevoort, *Taming the Animal Spirits*].

82. See, e.g., Richard A. Booth, *The Two Faces of Materiality*, 38 DEL. J. CORP. L. 518 (2013); John M. Newman Jr. et al., *Basic Truths: The Implications of the Fraud-on-the-Market Theory for Evaluating the "Misleading" and "Materiality" Elements of Securities Fraud Claims*, 20 J. CORP. L. 571 (1995); Dennis, *supra* note 75.

83. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 693-95 (1984) (explaining that unsophisticated investors can take "a free ride on the information impounded by the market: they get the same price received by the professional traders without having to do any of the work of learning information"); Newman Jr. et al., *supra* note 82, at 574 (citing evidence that it is "market professionals, and not individual stockholders, who set the price of securities"); see also Alicia Davis Evans, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1105 (2009) ("There is no question that U.S. securities markets are now dominated by institutional investors."); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1026 (2009) [hereinafter Langevoort, *Retail Investors*] ("The last thirty years or so have brought a rapid shift toward institutionalization in the financial markets in the United States—in other words, a shift toward investment by mutual funds, pension funds, insurance companies, bank trust departments, and the like. That the market for corporate securities traded on the New York Stock Exchange or the NASDAQ Global Market is no longer substantially retail in nature is now common knowledge.").

84. This argument clearly does not extend to communications that are specifically targeted at retail investors—such as marketing materials disseminated by mutual funds and brokers. See *infra* text accompanying notes 208–212.

85. The fraud-on-the-market theory was first adopted by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). It was recently reaffirmed in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014).

86. See, e.g., Newman Jr. et al., *supra* note 82, at 572 ("In modern securities markets, prices are determined not by individual amateur investors, but rather by investment professionals. A piece of alleged misinformation will not affect the price of a security when it is not believed by professional investors, or is thought by them to be unimportant. This is true no matter how the information might be perceived by a more generalized, hypothetical 'reasonable investor.'"); Langevoort, *Half-Truths*, *supra* note 66, at 105 ("[O]pen market fraud leads purchasers and sellers to trade in organized markets, where the ability of any given trader to affect the price at which the transaction occurs is minimal. If the market is characterized by a high level of efficiency, the orthodox assumption is that smart money dominates so that even if less sophisticated investors are fooled by some publicity, stock prices stay in line with assessments of fundamental value based on all publicly available information. Hence the average investor, even if fooled, is not significantly harmed.").

secondary market trading activity, underwriters set prices based on an understanding of what sophisticated institutional investors—the major participants in registered public offerings—are willing to pay. Normatively, the claim is that the law should not endorse a conception of the reasonable investor that might encourage retail investors to engage in stock picking, a practice that modern portfolio theory teaches is a losing proposition for all but the quickest and savviest.⁸⁷

In another camp are those who criticize the assumption of rationality that underlies judicial conceptions of the reasonable investor. In the spirit of behavioral critiques of the Hand Formula in tort, these scholars point to mounting evidence that real investors lack the ability to comprehend and synthesize information in a perfect and dispassionate manner, and instead allow emotions, biases, and irrelevant stimuli to affect their investment choices.⁸⁸ Descriptively, the import of this claim is clear: the rational retail investor envisioned, however murkily, in judicial opinions may simply not exist. Normatively, the import is less clear. One possible implication, suggested by some, is that the law ought to recognize and incorporate behavioral biases into the reasonable investor standard.⁸⁹ But this response encounters difficulties related to both feasibility and desirability. As Professors Choi and Pritchard have observed, “[a]djusting information disclosure to ameliorate behavioral biases of investors is a difficult and error-prone task.”⁹⁰ Moreover, doing so could have bad public policy consequences, if it leads investors to be less skeptical in interpreting information and thus more exposed to fraud, or if “limiting information flows for the benefit of the behaviorally challenged [] undermine[s] the ability of more

87. See, e.g., Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 175 (observing that the SEC’s message of empowerment to retail investors presents risks by fueling overconfidence about their ability to participate profitably in the capital markets).

88. See, e.g., Hoffman, “Duty” To Be A Rational Shareholder, *supra* note 75, at 543 (reviewing behavioralism literature argued to “undermine[] traditional assumptions of shareholder rationality”); Black, *supra* note 75, at 1496–97 (“Behavioral economists . . . do not observe real people investing in today’s markets behaving as the reasonable investors that federal securities law expects them to be To date, courts have not acknowledged this gap between judicial expectations about the behavior of reasonable investors and behavioral economists’ views of investors’ cognitive shortcomings.”); Lin, *The New Investor*, *supra* note 74, at 699 (noting the disconnect between the reasonable investor, imagined as a rational economic actor, and the real human investor, plagued by irrational biases and heuristics, but noting that “most of the regulatory framework continues to exist for the mythical, rational investor”). For an overview of evidence related to investor biases, see Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 139–47; Tom C.W. Lin, *A Behavioral Framework for Securities Risk*, 34 SEATTLE U.L. REV. 325, 340–49 (2011) [hereinafter Lin, *Behavioral Framework*]; Hoffman, “Duty” To Be A Rational Shareholder, *supra* note 75, at 549–62, 562.

89. See, e.g., Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99, 112 (2005) (arguing that behavioral insights counsel in favor of a “new definition for the materiality of information which focuses on the magnitude of the risky outcomes and on the degree or vividness of mental imagery”; “[i]n other words, determinations of materiality would and should depend not just on the cognitive form and content of information, but also upon the affective form or presentation and emotional content of that information”).

90. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 61 (2003); accord Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 138 (accepting the behavioralist view but observing that positive strategies “are hard to craft precisely because the alternative behavioral theories in the literature are so tentative”); Langevoort, *Half-Truths*, *supra* note 66, at 109 (“If we relax the assumption of market rationality, we enter into a normative freefall, for we can then assume nearly any level of foolishness in drawing inferences.”); see also Huang, *supra* note 89, at 121 (observing that the “contrast effect” and “recency effect” suggest that negative information that follows positive information will be given more attention by moody investors, whereas the “primacy effect” and “priming effect” suggests the opposite).

rational investors to value securities accurately.”⁹¹ Another possible normative takeaway of the behavioral critique is that it renders the “professional trader” and/or market-based conception of the reasonable investor, outlined above, all the more compelling. This assumes that professional traders are less prone to behavioral biases than retail investors and/or that such biases are likely to be largely washed out at the market level.⁹² Promotion of retail investor education is yet another possible policy response to behavioral critiques of the reasonable investor standard, one that would not necessitate any change to the standard itself.⁹³

B. The Role of Context

Many complain that the murky and arguably incoherent image of the reasonable investor painted by the case law makes it difficult for corporate issuers and their agents to both make disclosure choices *ex ante* and to defend those choices *ex post*, when confronted with litigation.⁹⁴ This difficulty is exacerbated by the highly contextual nature of the inquiry called for by the reasonable investor standard.⁹⁵

The Supreme Court has repeatedly stressed the need for such an inquiry. For example, in *TSC* the Court explained that

91. Choi & Pritchard, *supra* note 90, at 50, 61; Langevoort, *Half-Truths*, *supra* note 66, at 111 (observing that one “might say that the costs associated with intervening to help noise traders exceed whatever social benefit (if any) we might anticipate from the intervention, or that withholding assistance might encourage noise traders to be more careful”); *cf.* Huang, *supra* note 89, at 111 (“Courts have not eliminated and will not even necessarily reduce moody investing [simply] by holding that moody investing behavior is not reasonable, especially if moody investing is prevalent and unconscious.”).

92. While widely held views, some question the validity of these assumptions. *See, e.g.*, Huang, *supra* note 89, at 103 (surveying empirical data that non-cognitive investing “not only occurs, but also affects securities prices and market performance”); Hoffman, “Duty” *To Be A Rational Shareholder*, *supra* note 75, at 549 (arguing that behavioral biases will not always be washed out in the capital markets); Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 143 (observing that if the cognitive biases of investors “are systematic enough they will have an impact on prices that others do not arbitrage away”); *see also id.* at 148–52 (surveying arguments proffered in response to claims that inefficiencies in the market will be eliminated through arbitrage activities by the “smart money” and through use of de-biasing investment advice); Lin, *Behavioral Framework*, *supra* note 88, at 374–76 (noting that “[c]ritiques of behavioral approaches to securities regulation have suggested that such approaches are futile and unnecessary because arbitrage and efficient markets can adequately protect investors,” but arguing that “arbitrage alone cannot fully address securities risk”).

93. *See, e.g.*, Heminway, *supra* note 74, at 330–31 (observing that “barriers to knowledge and understanding (even barriers created by cognitive biases) may be overcome with targeted investor education.”); *but cf.* Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 187–88 (expressing doubt about the ability of investor education to successfully de-bias investors).

94. *See, e.g.*, Sauer, *supra* note 65, at 319 (observing that materiality “is a notoriously slippery concept, unpredictable and elusive in application” and asserting that the “continuing uncertainty has increased the cost of generating and verifying financial information and has added to the amount of litigation burdening the corporate world”); Lee, *supra* note 64, at 675 (“Generally, practitioners and issuers’ legal counsel are perplexed by the elusiveness of the ‘materiality’ standard.”); Dennis, *supra* note 75, at 385 (“Courts and commentators have expressed considerable frustration with the application of the legal test of materiality.”); Booth, *supra* note 80, at 518 (“the courts have struggled mightily to determine when a fact is material . . .”).

95. *See, e.g.*, Sauer, *supra* note 65, at 319 (“Materiality determinations in individual cases tend to be so fact-specific that the accumulated body of published case law provides limited guidance for decision-making.”); *id.* at 321 (“Determining which facts if added, singly or in combination, to the ‘total mix’ of available information would have been important to investors in a specific stock on a specific day is a highly circumstantial inquiry.”); *see also* Lee, *supra* note 64, at 674–75 (discussing how context can influence a materiality determination).

the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a “reasonable shareholder” would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.⁹⁶

In *Basic*, the Court again endorsed a “fact-specific inquiry” into materiality.⁹⁷ *Basic* involved the materiality standard for merger negotiations; the Court held that a reasonable investor would consider both the probability of the merger being consummated and its magnitude, if consummated, in judging the importance of the information.⁹⁸ Thus, the Court instructed,

[w]hether merger discussions in any particular case are material. . .depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value.⁹⁹

“No particular event or factor short of closing the transaction,” the Court concluded, “need be either necessary or sufficient by itself to render merger discussions material.”¹⁰⁰

More recently, the Court in *Omnicare* once again emphasized the fact-specific nature of the reasonable investor inquiry. In determining whether a statement of opinion is misleading, the Court explained that a reasonable investor would consider it in its “full context.”¹⁰¹ An opinion statement “is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way,” because “[r]easonable investors understand that opinions sometimes rest on a weighing of competing facts; indeed, the presence of such facts is one reason why an issuer may frame a statement as an opinion, thus conveying uncertainty.”¹⁰² A reasonable investor would take a more discerning approach, the Court explained, paying attention to the specificity of the opinion, the type of document it appears in, “customs and practices of the relevant industries,” and the “surrounding text, including hedges, disclaimers, and apparently conflicting information,” among other factors.¹⁰³

C. Companies’ Plea for Bright-Line Rules

The indeterminacy generated by the fact-specific nature of the reasonable investor

96. TSC Indus. v. Northway, 426 U.S. 438, 450 (1976).

97. Basic Inc. v. Levinson, 485 U.S. 224, 239 (1988).

98. *Id.* at 238.

99. *Id.* at 239.

100. *Id.*

101. Omnicare, Inc., v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1330 (2015).

102. *Id.* at 1329.

103. *Id.* at 1329 n.8 & 1330.

standard has frustrated public companies and their advisors for decades. These parties complain that the standard provides them with too little guidance for making disclosure choices and fosters frivolous litigation.¹⁰⁴ Their preferred fix: replace the reasonable investor standard with bright-line rules.¹⁰⁵ Neither the SEC nor the Supreme Court has been receptive to their pleas.¹⁰⁶

To the contrary, in 1999 the SEC responded to the growing use of quantitative materiality benchmarks by issuing a bulletin expressly rejecting the practice. In *SEC Staff Accounting Bulletin: No. 99—Materiality* (“SAB 99”), the SEC staff stated its position that public companies and their auditors may not assume the immateriality of financial statement items that fall below any particular percentage threshold; instead, SAB 99 instructs that the magnitude of an item “is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations.”¹⁰⁷ Qualitative factors that speak “to the factual context in which the user of financial statements would view the financial statement item” must also be considered.¹⁰⁸ The Financial Accounting Standards Board (FASB) had earlier taken a similar position, announcing in its *Statement of Financial Accounting Concepts Statement No. 2*, that “no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.”¹⁰⁹

Although SAB 99 was issued with the laudable purpose of deterring earnings management,¹¹⁰ and provided some guidance on the qualitative factors that should be

104. See *supra* note 95; see also Langevoort, *Half-Truths*, *supra* note 66, at 125 (observing that there is little excuse for the “opaqueness in legislative or administrative policy and de facto delegation to the judiciary,” and suggesting that affirmative disclosure obligations be more carefully crafted).

105. See, e.g., Lee, *supra* note 64, at 667 (discussing issuers’ and auditors’ preference for bright-line quantitative tests of materiality); see also James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513 (2009) (arguing that issuer liability in fraud-on-the-market cases be limited to quantitatively large misstatements).

106. See, e.g., Lee, *supra* note 64, at 667 (discussing the SEC’s rejection of a bright-line approach in SAB 99); Padfield, *Immaterial Lies*, *supra* note 75, at 154 (“the Supreme Court has . . . warned against the use of bright-line rules”).

107. See SAB 99, *supra* note 16, at 45, 151. For a more fulsome description of SAB 99, see Sauer, *supra* note 65, at 336–41, and Glenn F. Miller, *Staff Accounting Bulletin No. 99: Another Ill-Advised Foray Into the Murky World of Qualitative Materiality*, 95 NW. U. L. REV. 361, 378–82 (2000). Prior to SAB 99, quantitative standards were more commonly employed, and earlier efforts by the SEC to adopt a qualitative approach to materiality were rebuffed by the courts. For this history, see John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41 (1998) (discussing the SEC’s efforts in the wake of Watergate to adopt qualitative standards of materiality focused on corporate ethics). See also Redwood, *supra* note 61, at 338–60 (recounting the rise and fall of qualitative materiality as it concerns issues related to corporate integrity).

108. *Id.*

109. See FASB, *supra* note 65, ¶131.

110. SAB 99 was released in the wake of a speech by then-SEC Chairman Arthur Levitt calling out companies for engaging in earnings management. As Levitt explained:

[C]ompanies misuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that’s the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up that last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly. . . . “It doesn’t matter. It’s immaterial.”

looked to in determining the materiality of financial statement items,¹¹¹ it received an incredibly harsh reception by the industry. As one treatise explains, “[d]espite the SEC’s good intentions in providing guidance, SAB 99’s push for ‘qualitative materiality’ has been roundly criticized” as “excessively unclear and ‘nebulous’” and as “vague and impossible to implement.”¹¹² This has led “practitioners and financial professionals [to push] for ‘a clearer and more rational basis for assessing materiality with respect to financial misstatements.’”¹¹³

Thus far, their efforts have not been rewarded by the Supreme Court. Instead, the Supreme Court has taken every opportunity it has been presented with to reject bright-line alternatives to the reasonable investor standard. In *Basic*, for example, the Court rejected the defendants’ preferred “agreement-in-principle” test, under which preliminary merger negotiations would be deemed immaterial unless and until an agreement-in-principle had been reached between the parties related to price and deal structure.¹¹⁴ The Court acknowledged that a “bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in light of all the circumstances,” but declined to adopt it, noting that “[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality must necessarily be over- or under-inclusive.”¹¹⁵ The Court again declined to adopt a bright-line standard for materiality in *Matrixx Initiatives, Inc. v. Siracusano*.¹¹⁶ The defendant in that case argued for a rule that would render adverse events allegedly caused by a pharmaceutical product immaterial as a matter of law if too few in number to establish a statistically significant risk of causation; such an approach, the Court explained, would be at odds with the contextual inquiry called for by the reasonable investor standard.¹¹⁷ Most recently, the Court in *Omnicare* rejected the defendant’s position that “no reasonable person, in any context, can understand a statement of opinion to convey anything more than the speaker’s own mindset,” adopting

Arthur Levitt, *The “Numbers Game,”* Remarks at the N.Y.U. Center for Law and Business (Sept. 28, 1998), <https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>. See also Park, *supra* note 105, at 517 (observing that “critics of the qualitative standard do little to acknowledge that a quantitative standard can be a blank check for earnings manipulation”).

111. SAB 99, *supra* note 16 at 45, 152 (offering a non-exhaustive list of circumstances that may affect the materiality of quantitatively small misstatements). Additional guidance on materiality, also of limited usefulness, has been provided by the SEC and FASB. See, e.g., Selective Disclosure and Insider Trading: Final Rule, 65 Fed. Reg. 51,716, 51,721, 51,722 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249); FASB, *supra* note 65.

112. CARLA GARRETT ET AL., LAWYERS GUIDE TO FORMULAS IN DEAL DOCUMENTS AND SEC FILINGS § 6.11 (2016). See also Kenneth C. Fang & Brad Jacobs, *Clarifying and Protecting Materiality Standards in Financial Statements: A Review of SEC Staff Accounting Bulletin 99*, 55 BUS. LAW. 1039, 1050 (2000) (“Although the Commission attempts [in SAB 99] to clarify the materiality standard by eliminating the sole use of quantitative thresholds, the SEC actually blurs the lines for issuers and raises more questions than it answers.”); Wendy Gerwick Couture, *Materiality and a Theory of Legal Circularity*, 17 U. PA. J. BUS. L. 453, 523 (2015) (observing that SAB 99 “has been heavily criticized as nebulous”); Miller, *supra* note 107, at 396 (“By ending the custom of exclusive reliance on quantitative factors in making the materiality assessment and substituting a qualitative approach, SAB No. 99 greatly complicates the financial reporting process. It replaces a binary decision based on rigid, numerical benchmarks with a fluid, subjective decision, which may result in confusion and inconsistency in disclosure.”).

113. GARRETT ET AL., *supra* note 112.

114. *Basic Inc. v. Levinson*, 485 U.S. 224, 233 (1988).

115. *Id.* at 236.

116. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011).

117. *Id.* at 1321.

instead the highly contextualized approach to the question of an opinion's "misleadingness" described above.¹¹⁸

The lower courts have proven a more sympathetic audience for industry's complaints. A variety of judge-made doctrines have developed which deem particular types of statements immaterial as a matter of law, allowing courts to dismiss claims on materiality grounds before trial. These include the "puffery doctrine" (according to which "statements that are too vague, promotional, or hyperbolic constitute mere puffery and are therefore immaterial as a matter of law"¹¹⁹), the "bespeaks caution doctrine" (according to which forward-looking representations will be deemed immaterial as a matter of law if accompanied by sufficient cautionary language or risk disclosure¹²⁰), and the "truth on the market doctrine" (according to which a court will presume immateriality if "the allegedly misrepresented or omitted information was actually known to the 'smart money' segment of the marketplace"¹²¹), among others.¹²² Many scholars believe that judges use these doctrines "as a safety valve for frivolous litigation, which is only effective if the pressure is released pretrial."¹²³

118. See *supra* notes 101–103 and accompanying text.

119. Huang, *supra* note 89, at 113. For background on the puffery doctrine, see Padfield, *Is Puffery Material*, *supra* note 74 at 350–53, and Adi Osovsky, Puffery on the Market: A Behavioral Economic Analysis of the Puffery Defense in the Securities Arena 4–13 (unpublished manuscript) (May 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2603051. For an overview and examples of the courts' application of the puffery defense to both brokers and issuers, see Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1706–15 (1998).

120. Donald C. Langevoort, *Disclosures that Bespeak Caution*, 49 BUS. L.W. 481, 482 (1994) [hereinafter Langevoort, *Disclosures that Bespeak Caution*]. For a description of this doctrine, see Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind*, 58 U. PITTS. L. REV. 619 (1997).

121. Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 177.

122. See Hoffman, "Duty" To Be A Rational Shareholder, *supra* note 75, at 575–82 (discussing various additional techniques that courts use to decide materiality as a matter of law, including: (1) the "zero price change" rationale, under which courts dismiss claims where the alleged misstatement had no market effect; (2) the "trivial matters" rationale, under which courts dismiss claims involving nondisclosures relating to small percentages of total sales or revenues; (3) the "duty to read" rationale, under which courts hold an oral or written statement immaterial as a matter of law because other corporate disclosures negated its significance; and (4) the "understand consequences" rationale, under which courts dismiss claims where alleged omissions should have been inferred from the information actually disclosed); Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 119–25 (2002) (same); Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line*, 34 PEPP. L. REV. 927 (2007) [hereinafter Padfield, *Who Should Do the Math?*] (discussing the so-called "simple math" rule).

123. Padfield, *Immaterial Lies*, *supra* note 75, at 154; see also Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: the SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 479 (2001) [hereinafter Langevoort, *Seeking Sunlight*] ("One cannot read the case law under Rule 10b-5 since 1975 without a palpable sense that lawmaking has been driven by a fear of speculative litigation that had to be deterred, even at the price of making good cases harder to bring.... Most potently, perhaps, has been its influence in the development of entirely new (or reinvented) doctrines under the securities laws, [such as] the 'bespeaks caution' doctrine [and] the reinvigoration of an extraordinarily powerful 'mere puffery' defense"); cf. Bainbridge & Gulati, *supra* note 122, at 121–22 (describing the theory that "judges are using puffery to effect a policy agenda of limiting a class of cases perceived as frivolous" as plausible, but finding it ultimately less convincing than the theory that judges, facing various institutional constraints, use decision-making heuristics to rid themselves of complex cases early in the litigation); Hoffman, "Duty" To Be A Rational Shareholder, *supra* note 75, 569–74

These “safety valve” doctrines clearly stand in tension with the Supreme Court precedent discussed above. Because it turns on a “delicate assessment” of inferences to be drawn from highly contextualized facts, the reasonable investor standard is rarely appropriately decided as a matter of law. In *TSC*, the Court instructed that only if the challenged disclosures are “so obviously important [or unimportant] to an investor, that reasonable minds cannot differ on the question of materiality is the ultimate issue of materiality appropriately resolved as a matter of law.”¹²⁴ Indeed, the Court observed that in the “analogous context” of negligence, “the jury’s unique competence in applying the ‘reasonable man’ standard is thought ordinarily to preclude summary judgment.”¹²⁵ This has led courts to “utter a common refrain asserting that the analysis of materiality is extremely fact-intensive and thus is rarely to be decided on the basis of pretrial motions to dismiss or summary judgment.”¹²⁶ Yet the doctrines described above are far from rarely invoked; to the contrary, they are increasingly used to dispose of close cases.¹²⁷

This phenomenon has been the subject of substantial academic criticism. Scholars contend that courts’ aggressive use of these doctrines is lawless—not merely in the sense that it contravenes Supreme Court precedent, but also in the sense that it leads to poor and unprincipled decisions.¹²⁸ For example, Professors Bainbridge and Gulati mock the idea

(evaluating various hypotheses for courts’ use of these doctrines, including the ‘corporate activity’ hypothesis, the ‘conservative’ and ‘lazy judges’ hypothesis, and the ‘docket-pruning’ hypothesis).

124. *TSC Indus. v. Northway*, 426 U.S. 438, 450 (1976) (internal quotations omitted).

125. *Id.* at 450 n.12.

126. Padfield, *Immaterial Lies*, *supra* note 75, at 153–54; *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir. 1989) (determination of materiality in securities fraud cases “should ordinarily be left to the trier of fact”); *see also* Booth, *supra* note 82, at 536 (“the Court has effectively prohibited summary judgment on the question of materiality”); Hoffman, “*Duty* To Be A Rational Shareholder,” *supra* note 75, at 541 (the “[c]onventional wisdom” that “materiality issues in securities cases are almost always left for jury resolution”).

127. See, e.g., Hoffman, “*Duty* To Be A Rational Shareholder,” *supra* note 75, at 564, 585 (finding, in a sample of 385 securities cases involving a holding on materiality, that courts found at least one claim immaterial as a matter of law in 44% of all cases and in 51% of cases brought by a private plaintiff); Bainbridge & Gulati, *supra* note 122, at 116 n.94 (“[A]ccording to our survey of opinions, the question of materiality that is ‘ordinarily’ to be a question for the trier of fact and is to be decided in favor of the defendant at a threshold stage only if it is so ‘obvious’ that reasonable minds could not differ, turns out to be the subject of extensive [pretrial] discussion in the majority of cases. Of the 91 (out of 100) cases that were decided at the motion to dismiss stage, 64 involved materiality determinations in favor of the defendants (i.e., over 70%). In other words, what is supposed to be rare and unusual, turns out to be routine.”); Osovsky, *supra* note 119, at 13–14 (empirical study finding 233 securities cases mentioning the puffery defense in the five year period 2009–2013; of these, 73% (171 cases) accepted the defense); Wendy Gerwick Couture, *Around the World of Securities Fraud in Eighty Motions to Dismiss*, 45 LOY. U. CHI. L.J. 553, 559 (2014) (analyzing 80 opinions on motions to dismiss securities fraud class actions that were issued in 2013 and finding that in 19% of the opinions courts granted dismissal, at least in part, on the basis that a representation was immaterial as a matter of law); *see also* Padfield, *Is Puffery Material*, *supra* note 74, at 340 (“materiality is often resolved pretrial”); Osovsky, *supra* note 119, at 14 (noting the “rising popularity of the puffery defense in the last three decades”); Langevoort, *Seeking Sunlight*, *supra* note 123, at 479 (noting the “stunning willingness of judges to decide difficult materiality issues ‘as a matter of law’”).

128. See, e.g., David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1397 (2006) [*hereinafter Hoffman, Best Puffery Article Ever*] (noting that “many jurists [have] conclude[d] that the puffery defense is lawless”); Osovsky, *supra* note 119, at 1 (empirical study finding that court decisions on puffery tend to “lack reasoned analysis”); O’Hare, *supra* note 119, at 1722–26 (arguing that the puffery defense should not be applied in securities cases at all, because it is based on a policy of caveat emptor which has been rejected by the federal securities laws); *id.* at 1726–27 (criticizing courts invoking the puffery defense for relying “almost exclusively on the words of the company’s statement, while ignoring other factors that might lead a reasonable

that “judges possess the sophisticated understanding of investor behavior and market dynamics necessary to validate” these doctrines, given their lack of financial expertise and routine failure to consult the financial economics literature or any actual evidence of investor behavior in making materiality determinations.¹²⁹ Professor Hoffman similarly complains that judges frequently make materiality determinations based on little more than “judicial hunches,”¹³⁰ “treat[ing] puffery doctrine as a kind of semantic inquiry” rather than “considering evidence of actual [investor] reaction to puffing speech.”¹³¹ “[T]his interpretative approach,” he warns, “has led authorities to adopt a distorted view” of investor behavior.¹³² Professor Langevoort has similarly warned that judges deciding questions of materiality without the benefit of evidence “have little choice but to draw implicitly on their own knowledge and experience,” which “introduces a serious risk of unconscious bias.”¹³³

Until recently, district courts would also occasionally decide materiality at the class certification stage. In Rule 10b-5 cases alleging misrepresentations, the fraud-on-the-market (FOTM) presumption of reliance is key to class certification; without it individualized issues of reliance would overwhelm common ones, in contravention of the predominance requirement of Federal Rule of Civil Procedure 23(b)(3).¹³⁴ Because materiality is one of the prerequisites for invoking the FOTM presumption,¹³⁵ courts sometimes insisted that plaintiffs prove it in order to obtain certification, even though

investor to conclude that the statement was important to the investment decision”); Hoffman, “*Duty* To Be A Rational Shareholder, *supra* note 75, at 586–90 (arguing that behavioral insights undermine assumptions about investor behavior that underlie the puffery and bespeaks caution doctrines); Padfield, *Is Puffery Material*, *supra* note 74, at 357–61 (noting the criticism that the puffery doctrine is inconsistent with the weight real investors actually place on vague corporate statements); cf. Osovsky, *supra* note 119, at 1 (finding, based on survey evidence, “that the courts’ assumption that puffery statements do not affect investment decisions is correct in most instances” but warning that “a cautious analysis” is called for with respect to “strong puffery statements”).

129. Bainbridge & Gulati, *supra* note 122, at 120–21; *see also id.* at 137–38 (warning that judges use of materiality-heuristics can lead to skewed and mediocre doctrine and create safe harbors for bad behavior).

130. Hoffman, “*Duty* To Be A Rational Shareholder, *supra* note 75, at 607.

131. Hoffman, *Best Puffery Article Ever*, *supra* note 128, at 1440.

132. *Id.*

133. Langevoort, *Disclosures that Bespeak Caution*, *supra* note 120, at 493. Some scholars have also argued that when courts invoke these doctrines to rule on materiality at the pretrial phase, they improperly usurp the role of the jury. *See, e.g.*, Huang, *supra* note 89, at 117; Osovsky, *supra* note 119, at 18. This complaint is somewhat specious, however. The reality is that if the reasonable investor standard is not applied by the court prior to trial, it will in all likelihood not be applied at all. This is because, if not dismissed pretrial, securities class actions almost inevitably settle. *See, e.g.*, Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 178 n.181. The size of the potential liability, combined with the uncertainty of the outcome, makes trial simply too great a risk from the viewpoint of corporate defendants and those who advise them. *See, e.g.*, Padfield, *Who Should Do the Math?*, *supra* note 122, at 945. This, in turn, may encourage the filing of borderline cases. As explained above, judicial concern with this reality has likely spurred the development of the “safety valve” doctrines in the first place. *See supra* note 123 and accompanying text.

134. *Basic Inc. v. Levinson*, 485 U.S. 224, 242 (1988). The FOTM presumption is not required to certify a Rule 10b-5 class action alleging omissions, because in such cases positive proof of reliance need not be shown. *See Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). Nor is it required to certify a Section 11 class action, since reliance is not an element under Section 11. *See* 15 U.S.C. § 77k (1998).

135. To invoke the FOTM presumption, plaintiffs must show “(1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiffs traded the stock between the time the misrepresentations were made and when the truth was revealed.” *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2408 (2014).

materiality is also an element of a Rule 10b-5 claim on the merits.¹³⁶ In *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds* the Supreme Court shut this practice down, holding that although materiality must be shown for the FOTM presumption to apply, it should not be adjudicated as part of class certification.¹³⁷ Reserving the issue for trial does not offend Rule 23(b)(3)'s predominance requirement, the Court explained, because a failure of proof on the element would not result in ““some fatal dissimilarity’ among class members that would make use of the class-action device inefficient or unfair.”¹³⁸ To the contrary, “[a]bsent proof of materiality, the claim of the Rule 10b-5 class will fail in its entirety; there will be no remaining individual questions to adjudicate.”¹³⁹

The *Amgen* Court was not swayed by the defendant's argument that reserving the materiality determination for trial would foster strike suits, noting that Congress had already taken steps to curb abusive securities litigation in the PSLRA.¹⁴⁰ “We have no warrant to encumber securities-fraud litigation by adopting an atextual requirement of precertification proof of materiality that Congress, despite its extensive involvement in the securities field, has not sanctioned,” the Court wrote.¹⁴¹ The impact of Congress' enactment of the PSLRA on the debate over the reasonable investor test is considered more fully below.

D. The Impact of the PSLRA

Some contend that concerns about the vagueness of the reasonable investor standard are overblown in light of reforms enacted by the PSLRA. Specifically, it has been argued that in light of the PSLRA's heightened scienter pleading requirement, the materiality element of the Rule 10b-5 cause of action has waned in functional importance.¹⁴² After all, if someone intentionally or recklessly made a false statement, the fact that the statement may have been immaterial hardly seems to excuse the behavior; it is only when we do not trust the scienter screen that materiality serves as an important safeguard against truly non-meritorious suits.¹⁴³ While there is some force to this argument, it takes too narrow a view. For several reasons, complaints about the vagueness of the reasonable investor standard

136. See, e.g., *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 484–86 & n.9 (2d Cir. 2008); see also *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631–32, 637–38 (3d Cir. 2011) (stating that plaintiff need not prove materiality before class certification, but defendant may present rebuttal evidence on the issue).

137. See generally *Amgen Inc. v. Conn. Ret. Plans and Tr. Funds*, 133 S. Ct. 1184 (2013).

138. *Id.* at 1197 (quoting Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. REV. 97, 107 (2009)).

139. *Id.* at 1196.

140. See *id.* at 1199–1202; cf. *id.* at 1206 (Scalia, J., dissenting) (“Certification of the class is often, if not usually, the prelude to a substantial settlement by the defendant because the costs and risks of litigating further are so high.”).

141. *Amgen Inc. v. Conn. Ret. Plans and Tr. Funds*, 133 S. Ct. 1184, 1202 (2013).

142. Padfield, *Immaterial Lies*, *supra* note 75, at 144, 180–93.

143. It is a small burden to avoid intentional or reckless misstatements. It is quite another to avoid innocent misstatements, which is what a potential Rule 10b-5 defendant who feared misapplication of Rule 10b-5's scienter requirement might strive to do. In such a situation, the materiality element offers relief. As Richard Sauer has explained, “[a]llowing a margin of error avoids costly efforts to measure the trivial or inherently subjective aspects of business activity. That margin is important not only to managers, who should be primarily engaged in improving, rather than measuring, the performance of their companies, but also to auditors, who are called upon to assess the reliability of financial statements through procedures that can never provide absolute certainty.” Sauer, *supra* note 65, at 318.

continue to merit thoughtful consideration in a post-PSLRA world.¹⁴⁴

Recall, for example, that the reasonable investor standard defines the concept of “misleadingness” as well as the element of materiality. As explained above, whether a defendant should be held liable for a statement that is not in itself a misstatement of fact, but which is alleged to be misleading because of the omission of other information, requires the fact finder to assess what a reasonable investor would infer from the statement standing alone. If it is difficult to predict the outcome of that determination, an issuer might decide to omit the statement altogether, or alternatively to disclose additional extraneous facts out of an abundance of caution—either approach risks reducing the usefulness of corporate disclosures to investors. The heightened scienter pleading required of Rule 10b-5 plaintiffs under the PSLRA provides little comfort to issuers in this situation. Whereas that requirement creates a real barrier to frivolous claims alleging that defendants knew, or were reckless in not knowing, the falsity of an affirmative misstatement, scienter operates differently in half-truth cases. In such cases, scienter turns on whether the defendant knew, or was reckless in not knowing, that a reasonable investor would have viewed the challenged statement as misleading. Thus, as a practical matter, scienter takes a backseat to the reasonable investor inquiry.

The same can be said with respect to pure omission claims. As explained at the outset of Part III, mandatory disclosure obligations under the federal securities laws are often by their terms limited to “material” information. For example, Item 303(a)(1) of Regulation S-K requires disclosure of known trends, demands, commitments, events or uncertainties likely to result in a company’s liquidity changing “in any material way.”¹⁴⁵ The scienter issue in pure omissions cases thus tends to devolve into the question of whether the issuer knew, or was reckless in not knowing, the materiality of the omitted item—*viz.*, whether a reasonable investor would have considered the information important. Uncertainty surrounding the concept of the reasonable investor may therefore result in excessive disclosure, as companies attempt to avoid litigation.¹⁴⁶

Scienter is not even an element of plaintiffs’ *prima facie* case under Section 11, so the PSLRA’s heightened scienter pleading requirement plays no role at all in this type of litigation.¹⁴⁷ A plaintiffs’ *prima facie* case in a Section 11 case turns almost entirely on

144. To be sure, the merits likely matter more to the outcome of securities class actions than they did prior to the adoption of the PSLRA, although empirical attempts to quantify the impact of the merits on settlements are fraught with difficulty. *See generally* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1477–98 (2004) (surveying empirical work examining the impact of the PSLRA). But qualitative research suggests that non-merits factors continue to play a role in settlement negotiations (Tom Baker & Sean Griffith, *How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 823 (2009)), something that standard theoretical models of frivolous litigation would predict (*see, e.g.*, Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251, 1294–1301 (2002) (discussing these models)).

145. 17 C.F.R. § 229.303(a)(1) (2017). Whether Item 303 creates a duty to disclose that is actionable under Rule 10b-5 is a question currently pending before the United States Supreme Court. *See Leidos, Inc. v. Ind. Pub. Ret. Sys.*, 137 S. Ct. 1395 (2017).

146. As a former SEC chairperson recently remarked, “ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant.” Mary Jo White, Chair, SEC, *The Path Forward on Disclosure*, Speech at the National Association of Corporate Directors—Leadership Conference (Oct. 15, 2013), <https://www.sec.gov/News/Speech/Detail/Speech/1370539878806>.

147. Section 11 imposes strict liability on issuer defendants; other Section 11 defendants may raise due diligence as an affirmative defense. *See* 15 U.S.C. §77k (1998).

whether the plaintiff can plead and prove that the issuer’s registration statement contained a material misstatement of fact, a materially misleading “half-truth,” and/or the omission of a material fact required to be stated therein.¹⁴⁸ One may rightly have little patience for misstatements of fact in a registration statement, even if legally “immaterial,” given the careful fact-checking that should accompany the statement’s preparation. But liability for half-truths and omissions is much harder (and more costly) for an issuer to protect against, and given the extremely large damage awards available to plaintiffs in Section 11 class actions, raises legitimate over-deterrence concerns.¹⁴⁹

It might also be noted that the SEC is not bound by the PSLRA’s heightened pleading requirements when it brings suit under Rule 10b-5, just as it is not so bound when it brings negligence-based claims for material misrepresentations, half-truths and omissions pursuant to Section 17(a) of the Securities Act of 1933.¹⁵⁰ But the SEC’s freedom from the strictures of the PSLRA is of lesser significance than the points made above. It is the fear of frivolous securities class actions, far more than the fear of frivolous SEC-enforcement actions, which animates concerns about the vagueness of the reasonable investor test. Consistent with this conventional wisdom, empirical research shows that courts invoke the materiality “safety valve” doctrines discussed above with dramatically greater frequency in lawsuits brought by private plaintiffs relative to cases brought by the SEC.¹⁵¹

The prevalent use of these safety-valve doctrines brings up a final point that warrants emphasis: regardless of the true strength of company complaints about the reasonable investor standard, the lower courts appear to be responding to them by invoking “immortal as a matter of law” doctrines to dismiss securities class actions at alarming rates.¹⁵² This alone warrants taking a critical look at the arguments being advanced.

IV. THE REASONABLE INVESTOR VS. THE REASONABLE PERSON

Both critics and defenders of the reasonable investor test have tended to cast their arguments in terms of the perennial “rules versus standards” debate. The tradeoffs occasioned by the choice between rules and standards are well-trodden territory in the legal literature¹⁵³: relative to standards, rules may invoke greater compliance by regulated parties because more certain,¹⁵⁴ but are also likely to be under- and over-inclusive, such that the compliance achieved may deviate in significant ways from what is socially

148. Plaintiffs in Section 11 cases need not prove reliance or causation as part of their *prima facie* case. See *id.*

149. See 15 U.S.C. § 77k(e) (2012) (detailing the measure of damages); see also Joseph A. Grundfest, Morrison, the *Restricted Scope of Securities Act Section 11 Liability, and Prospects for Regulatory Reform*, 41 J. CORP. L. 1, 3 (2015) (observing that “Section 11 liability is the source of many of the largest class action securities recoveries in history”).

150. 15 U.S.C. § 77q (2010).

151. See Hoffman, “Duty” To Be A Rational Shareholder, *supra* note 75, at 567–68 (finding, in sample of 385 securities cases involving a holding on materiality, that courts found at least one claim immaterial as a matter of law in 50.9% of cases brought by private plaintiffs as compared to only 6.5% of cases brought by the SEC).

152. See *supra* notes 123 & 127.

153. For helpful overviews, see FRANCESCO PARISI & VINY FON, THE ECONOMICS OF LAWMAKING 9–29 (2009); Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165, 172–181 (2015); Kathleen M. Sullivan, *The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 57–69 (1992).

154. See, e.g., Issac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 262 (1974).

optimal¹⁵⁵; rules are more costly than standards to develop *ex ante*, but are far cheaper to apply *ex post*¹⁵⁶; rules do a better job of limiting frivolous litigation as well as cabining judicial discretion than standards,¹⁵⁷ but the rigidity rules impose on enforcers and fact-finders may lead to undesirable outcomes in specific cases.¹⁵⁸ Measuring these tradeoffs with any level of precision is, however, usually impossible. And although much scholarly ink has been spilt elaborating the factors that influence the magnitude of the costs and benefits associated with the specificity of a legal command,¹⁵⁹ these factors fail to point in a single direction when applied to the reasonable investor test.¹⁶⁰ Thus, so long as the reasonable investor debate continues to be argued in simplistic terms of rules versus standards—with market participants complaining of the uncertainty generated by the reasonable investor standard and the SEC and Supreme Court warning of the under-inclusiveness of the bright-line rules offered to replace it—the debate will prove intractable.

This Article approaches the issue differently, considering what, if anything, we might learn from the reasonable investor's predecessor—the “reasonable person” of tort law. The reasonable investor standard shares the same basic justification as the reasonable person standard: whether information is important or misleading requires an objective but at the same time highly contextualized analysis, making it difficult to craft *ex ante* rules on point that are not grossly over- or under-inclusive. Since the earliest uses of the reasonable person standard, defendants have complained about the uncertainty that surrounds its application, just as critics of the reasonable investor standard do today. But the reasonable person standard has nevertheless persevered through centuries of common law development, suggesting that its benefits outweigh its costs. This raises the question whether the reasonable investor standard differs from tort law's reasonable person standard in ways

155. See, e.g., Ehrlich & Posner, *supra* note 154, at 268; Sullivan, *supra* note 153, at 62–63, 66.

156. See, e.g., Colin Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 73–74 (1983); Parchomovsky & Stein, *supra* note 153, at 177.

157. See, e.g., Ehrlich & Posner, *supra* note 154, at 267; Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 609 (1992).

158. See, e.g., Sullivan, *supra* note 153, at 62, 66.

159. Factors stressed in the literature include the heterogeneity of the conduct to be regulated—the more heterogeneous the conduct, the higher the cost of generating rules (Ehrlich & Posner, *supra* note 154, at 267) and the greater the problem of under- and over-inclusion (*id.* at 268). It has also been observed that rule generation will be more costly the more politically controversial the issue (*id.*), whereas the benefits of incurring the fixed costs of detailing a rule are greater for rules that govern a larger amount of conduct (*id.* at 274; Kaplow, *supra* note 157, at 577; Diver, *supra* note 156, at 75). Scholars have further noted that the under- and over-inclusiveness of rules is of special concern if errors of misspecification are particularly costly given the regulated area, just as the uncertainty of standards is of special concern if errors of misapplication are particularly costly. *Id.* at 74. The likelihood of economic or technological change in a regulated area is another relevant factor, as rules suffer from obsolescence more than standards and thus can require costly updating. Ehrlich & Posner, *supra* note 154, at 277–78; Kaplow, *supra* note 157, at 616.

160. The concepts of materiality and misleadingness under the federal securities laws apply to a large amount of conduct, thus pointing toward the desirability of rules. Also favoring rules is the significance of errors of misapplication: given the large sanctions threatened in securities class actions, corporate issuers may respond to the threat of legal error by taking steps that diminish the usefulness of corporate disclosures, thus undermining the very purpose of federal securities regulation. But errors of misspecification will also undermine the federal securities laws' disclosure goals, and are very likely to occur given that the conduct to be regulated is quite heterogeneous. Moreover, disclosure rules can be politically divisive, and may suffer from obsolesce given rapid change in the capital markets. These latter factors favor a standards-based approach. See generally *supra* note 159.

that suggest it is less efficient.

Looking to the common law of tort for guidance in evaluating the liability provisions of the federal securities laws has a long tradition.¹⁶¹ Surprisingly, the reasonable investor test has never been subjected to such analysis. This Part fills that gap by comparing tort law’s reasonable person standard with the reasonable investor standard of the federal securities laws, identifying important differences. The exercise proves quite useful. To preview, the differences identified suggest that the reasonable investor standard is likely more costly than tort law’s reasonable person standard. But, as discussed in the next Part, they also suggest a different approach to reform than the move toward bright-line rules long advocated by critics of the reasonable investor standard.

* * * *

Just like the determination of the appropriate amount of care to be taken under the law of negligence, the determination of the meaning and import of corporate disclosures under the federal securities laws is appropriately done on an objective basis. A standard that varied based on the views of the defendant would be difficult to administer due to proof problems, and would fail to achieve the uniformity of disclosure practice across issuers that is one of the primary justifications for the federal system of mandatory disclosure.¹⁶² But, unlike with the reasonable person standard of a simple tort case, there is no reason to believe that the desired goal of objectivity can be achieved if the standard is left to juries to apply intuitively.

Recall that the use of juries has been cited as mitigating the uncertainty of tort law’s reasonable person standard since its inception.¹⁶³ The jury has always been viewed as not only competent to give meaning to the concept of reasonableness in a simple tort case, but as *uniquely* competent. Drawing on each members’ personal experiences, the jury’s decision in a simple tort case is relied upon to reflect “the conscience of the community” as to what level of care we expect of one another in daily life. The jury is counted on to channel this community conscience not just in how it takes account of the varied facts and circumstances of the particular case, but also by giving normative content to the very concept of reasonableness. Whether the “reasonable person” is a utilitarian or a Kantian, for example, or some context-dependent combination of the two, is left for the jury to decide implicitly. If a single judge were assigned these tasks instead, the decisions reached would be far less legitimate.

As explained in Part II, when we move from simple tort cases to cases involving specialized activities, relying on the intuitions of a lay jury to judge what is reasonable loses its appeal, and it follows that jury resolution of the issue becomes less important from a functional perspective. In such cases, juror determinations of reasonableness will be arbitrary and inconsistent unless informed by expert evidence. Juries have no special competence in evaluating expert evidence; indeed, some would argue that judges are better equipped than juries to serve as fact-finders on issues requiring expert testimony, because judges are better trained to comprehend what can be the highly complex material involved.¹⁶⁴ When we move away from simple tort cases to cases involving specialized

161. See *supra* notes 22–23 and accompanying text.

162. See, e.g., Easterbrook & Fischel, *supra* note 83, at 700 (“If every firm must disclose the same things, there will be reciprocal benefits to each firm’s investors. . .”).

163. See *supra* text accompanying note 47.

164. See Smith, *supra* note 49.

activities, relying on the jury to define the standard of care also ceases to make sense. Not only would the jury be an unqualified and illegitimate body to make this policy choice, but experts need an answer at the outset of the litigation so that they know what it is they are called to opine on.

Tort law's approach to cases alleging negligence in the provision of professional services is instructive. In such cases, the identity of the reasonable person is not left undefined, the way it is in a simple negligence case. Instead, the jury is instructed to judge the defendant's behavior against the behavior of a reasonable professional in the same field as the defendant.¹⁶⁵ And, in assessing how this reasonable professional would have behaved under the facts and circumstances of the particular case, jurors are not called upon to render a social judgment based upon their personal experiences, the way they would in a simple negligence case; rather, they must base their determination "only on the testimony of the expert witnesses."¹⁶⁶

Like the provision of professional services, securities investing is a specialized activity that most jurors will have had little to no personal experience with. Whereas almost every adult has had extensive experience driving a car, a majority of Americans have never invested in securities.¹⁶⁷ Ownership rates are particularly low among certain demographics. For example, a recent poll shows that only 15% of those earning less than \$30,000 a year and only 25% of those without a college degree have money invested in stocks.¹⁶⁸ Among the minority of Americans that do own securities, most do so only indirectly, through a mutual or pension fund, and thus have likely never read disclosure documents prepared by non-investment companies.¹⁶⁹ Even among the small subset of the population that purchases stock directly, most are unlikely to actually read public company disclosures.¹⁷⁰ The average American's lack of knowledge about securities investing is reflected in the dismal performance of most Americans on even basic financial literacy questionnaires.¹⁷¹

165. See *supra* note 48.

166. *Id.*

167. See, e.g., Alec Tyson, *Economic Recovery Favors the More Affluent Who Own Stocks*, PEW RES. CTR. (May 31, 2013), <http://www.pewresearch.org/fact-tank/2013/05/31/stocks-and-the-recovery-majority-of-americans-not-invested-in-the-market/> ("A Pew Research survey in March found that 53% of Americans say they have no money at all invested in the stock market, including retirement accounts"). Even fewer Americans own bonds than stocks. See John Sabelhaus et al., *Equity and Bond Ownership in America, 2008*, INV. COMPANY INST. & SECURITIES INDUSTRY AND FIN. MKTS. ASS'N 8 (2008), https://www.ici.org/pdf/rpt_08_equity_owners.pdf.

168. Tyson, *supra* note 167; see also Sabelhaus et al., *supra* note 167, at 16 fig.2.1. Civil juries, notably, are dominated by non-college graduates. See JOE CECIL ET AL., JURY SERV. IN LENGTHY CIV. TRIALS 19 tbl.4, FEDERAL JUDICIAL CENTER (1987).

169. For some time, the demand for directly held equities and bonds has been falling, while demand for mutual funds has been rising. See INV. CO. INST., INVESTMENT COMPANY FACT BOOK 11–12 (5th ed. 2015). See also Sabelhaus et al., *supra* note 167, at 24 fig.2.9. Even investment company disclosures often go unread, or are not read carefully. See Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 978–1008 (surveying research on the behavior of mutual fund investors).

170. Instead, most direct investors likely rely on the advice of an investment professional, or on the integrity of the market price. See, e.g., Amgen Inc. v. Conn. Ret. Plans and Tr. Funds, 133 S. Ct. 1184, 1192 (2013) ("[I]t is reasonable to presume that most investors—knowing that they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information—will rely on the security's market price as an unbiased assessment of the security's value in light of all public information.").

171. See Pa Bryn Mawr, *Crash Course Needed: Four Out of Five Americans Fail When Quizzed on How to Make Their Nest Eggs Last* (Dec. 3, 2014), <http://www.theamericancollege.edu/ricp-retirement-income-survey/press-release.php>.

It follows from this reality that the reasonable investor standard cannot be justified as providing a conduit for the jury to express its collective wisdom as to what is reasonable to expect in SEC filings or other corporate disclosures, akin to the way the reasonable person standard functions in a simple tort case. Most jurors will have no such wisdom, even if we conceive of the “reasonable investor” as an average retail investor. Thus, in securities cases—like in professional negligence cases in tort—some form of expert evidence will typically be necessary for fact-finders to reach informed and consistent judgments. This is hardly a radical proposition: in the small subset of federal securities cases that actually proceed to the merits (mostly SEC enforcement actions and criminal prosecutions), expert evidence is routinely offered to establish or disprove materiality.¹⁷²

Two conclusions flow from these observations. First, juror resolution of the reasonable investor standard is less important than juror resolution of the reasonable person standard in a simple tort case, given that such decisions should not be based on the jury’s social judgment but rather on some form of expert evidence. Second, and relatedly, the need to specify the reasonable investor’s identity is more pressing than in a simple tort case. Should event studies be required to show materiality, as is apparently the rule in the Third Circuit?¹⁷³ If survey evidence should be used to establish how a “reasonable investor” would have viewed challenged statements, as some scholars have advocated,¹⁷⁴ to whom should the surveys be directed? Is the viewpoint of market professionals probative and, if so, will testimony by any investment professional suffice or must they have experience in the defendant company’s industry? The answers to these questions depend entirely on how one conceives of the reasonable investor.

Unfortunately, as discussed in Part III.A, the reasonable investor’s identity is not specified in statute or SEC rule. Nor is it defined in jury instructions.¹⁷⁵ Instead, all that we know of the reasonable investor’s identity is found in murky, inconsistent, and arguably incoherent case law. This state of affairs stands in stark contrast to tort cases involving allegations of professional negligence, where the perspective that experts and fact-finders must take in assessing the reasonableness of the defendant’s conduct is clear. The reasonable investor standard is in this way left much more uncertain than tort law’s reasonable person standard.

To be sure, common law misrepresentation claims sometimes involved the sale of securities, and in those cases materiality was similarly left to juries to judge by reference to the import an undefined reasonable person would have attached to the challenged

172. See, e.g., United States v. Schiff, 602 F.3d 152, 171 n.26 (3d Cir. 2010) (noting that, in addition to using event studies to prove materiality, the government could use Wall Street analysts to “testify that a pharmaceutical company’s sales and the level of wholesaler inventory are material to their investment decisions and forecasts”); United States v. Reyes, 577 F.3d 1069, 1075 (9th Cir. 2009) (utilizing investment and accounting expert testimony on materiality); SEC v. Goldstone, 2016 U.S. Dist. LEXIS 61657, *145–151 (D.N.M. May 10, 2016) (using event studies as evidence of materiality).

173. See SEC v. Berlacher, 2010 U.S. Dist. LEXIS 95759, at *19–20 (E.D. Pa. Sept. 13, 2010) (interpreting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410 (3d Cir. 1997) in this way); accord *In re Merck & Co. Sec. Litig.*, 432 F.3d 261 (3d Cir. 2005).

174. E.g., Huang, *supra* note 89, at 114; Hoffman, “*Duty* To Be A Rational Shareholder,” *supra* note 75, at 607; Padfield, *Is Puffery Material*, *supra* note 74, at 341.

175. See, e.g., MANUAL OF MODEL CIVIL JURY INSTRUCTIONS FOR THE DIST. COURTS OF THE NINTH CIRCUIT § 18.2 (JURY INSTRUCTIONS COMM. 2007) (giving instruction on materiality in Rule 10b-5 cases).

information.¹⁷⁶ But, as the Supreme Court has observed, “the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions” at issue in modern securities class actions.¹⁷⁷ Common law misrepresentation cases involved face-to-face dealings between the plaintiff and defendant,¹⁷⁸ and they required the plaintiff to show that the defendant made the challenged misrepresentation with the specific intention of inducing the sale, and that the plaintiff actually and justifiably relied upon the defendant’s misrepresentation.¹⁷⁹ Thus, the jury was asked to judge whether, in a specific face-to-face transaction with a developed factual context, a reasonable person standing in the plaintiff’s shoes would have viewed the misrepresentation as important. The major liability provisions in the federal securities laws, by contrast, have been interpreted to allow shareholders who did not transact directly with the defendants to sue and to obtain recovery without proving actual reliance on the alleged misrepresentations.¹⁸⁰ As a result, juries in such cases must decide how a disembodied and undefined “reasonable investor” would judge the import of corporate information released generally into the marketplace—a much different task.

This takes us to the other important distinction between the reasonable investor standard and the reasonable person standard of the common law. The uncertainty generated by the reasonable investor standard is not only greater than the uncertainty generated by the reasonable person standard, it is also more problematic. This is because the stakes in securities class actions are dramatically higher than the stakes in traditional tort cases. In traditional tort cases, class certification was not an option—at first because the modern class device simply did not exist, and later because issues like reliance had to be proven on an individualized basis.¹⁸¹ Because the liability provisions of the federal securities laws can be enforced without a showing of traditional reliance, not only can more investors sue (including secondary market traders who did not read the challenged disclosures), but their claims are typically suitable for class treatment under Federal Rule of Civil Procedure 23(b)(3).¹⁸² As a result, securities class actions threaten public companies with a massive liability unheard of in common law misrepresentation cases,¹⁸³ such that even a small amount of uncertainty might distort issuer disclosure choices *ex ante*, and pressure defendants to settle *ex post*.¹⁸⁴ This potentially feeds an unvirtuous cycle by stunting the

176. Alternatively, the plaintiff could prove materiality by showing that the defendant knew or had reason to know that the plaintiff would regard the information as important. See RESTATEMENT (SECOND) TORTS § 538 (1977).

177. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744–45 (1975).

178. See *Basic Inc. v. Levinson*, 485 U.S. 224, 243–44 (1988) (“the modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases”).

179. RESTATEMENT (SECOND) OF TORTS § 525 (1977).

180. Amanda M. Rose, *Form vs. Function in Rule 10b-5 Class Actions*, 10 DUKE J. CONST. LAW & PUB. POL’Y 57, 59–60 (2015).

181. See THOMAS A. DICKERSON, CLASS ACTIONS: THE LAW OF 50 STATES §§ 1.02 & 6.04[5](a) (Law Journal Press; Lsif edition 2017).

182. See *supra* note 134 and accompanying text.

183. See, e.g., A.C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2007–08 CATO SUP. CT. REV. 217, 224 (“Given the trading volume in secondary markets, the potential recoverable damages in securities class actions can be a substantial percentage of the corporation’s total capitalization, easily reaching hundreds of millions of dollars, and sometimes billions.”).

184. Uncertainty over the application of the reasonable investor test is, of course, only one of several factors

development of clarifying precedent and encouraging the filing of borderline cases.¹⁸⁵

Reasonable minds might differ on how severe of a problem this is, and whether it requires a response, but one thing is clear: many lower courts view it as a problem, and are taking it upon themselves to address it.¹⁸⁶ Although the Supreme Court has instructed that the reasonable investor standard cannot be decided as a matter of law absent unusual circumstances, courts increasingly do so anyway under the guise of the “safety valve” doctrines discussed in Part III.C. Indeed, a substantial number of securities cases are disposed of pre-trial pursuant to these doctrines, despite frequent court statements to the effect that this is almost never appropriate.¹⁸⁷

This is hardly a phenomenon unique to securities cases. Lower courts have a knack of finding ways to release settlement pressure in high-stakes litigation, even when those techniques seemingly conflict with Supreme Court precedent or other positive law. For example, it is sometimes asserted that judges presiding over mass tort cases inappropriately resolve a “battle of the experts” under the guise of *Daubert*-gatekeeping, in order to dismiss cases on summary judgment.¹⁸⁸ In addition, some claim that before the Supreme Court actually heightened the standard for stating a claim in *Bell Atlantic Corp. v. Twombly*, the lower courts applied rigorous pleading standards in class actions.¹⁸⁹

Twombly highlights that the Supreme Court, too, is sometimes responsive to concerns about settlement pressure in aggregate litigation.¹⁹⁰ This clearly was not the case in *Amgen*,¹⁹¹ but has been a feature in many other Supreme Court securities decisions¹⁹²—including most recently in *Omnicare*.¹⁹³ The Court in *Omnicare* extended the reach of the reasonable investor test, but not without addressing the defendant’s concern that the decision would invite strike suits. The Court did so by emphasizing that pleading

that push securities class actions to settle. *See Baker & Griffith, supra* note 144 (discussing the complex incentives of insurance companies, individually named defendants, litigants and counsel in the settlement dynamic); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 505 (1991) (“a combination of factors including the parties’ economic incentives, transaction and agency costs, procedural and substantive rules of law, and the existence of insurance combine to make trial an unthinkable alternative”).

185. *See* Bone & Evans, *supra* note 144, at 1292 (“because plaintiffs file frivolous and weak cases to obtain a settlement, the greater prospect of settlement with successful certification should encourage plaintiffs to file more frivolous and weak cases”).

186. *See supra* note 123 and accompanying text.

187. *See supra* note 127.

188. *See, e.g.*, Allan Kanner & M. Ryan Casey, *Daubert and the Disappearing Jury Trial*, 69 U. PITTS. L. REV. 281 (2007).

189. *See* Jason A. Cantone et al., *Whither Notice Pleading?: Pleading Practice in the Days Before Twombly*, 39 S. ILL. U. L.J. 23 (2014); *see also* Brian Fitzpatrick, *Twombly & Iqbal Reconsidered*, 87 NOTRE DAME L. REV. 1621, 1629 (2012) (noting the view that “all the Supreme Court did in *Twombly* and *Iqbal* was catch up to what lower courts had been doing for some time”).

190. *See also* Chris Guthrie, *Framing Frivolous Litigation: A Psychological Theory*, 67 U. CHI. L. REV. 163, 164 (2000) (characterizing the Supreme Court’s trilogy of summary judgment cases—*Celotex Corp. v. Catrett*, 477 U.S. 317 (1986), *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986), and *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986)—as designed in part to deal with the strike suit problem).

191. *See Amgen Inc. v. Conn. Ret. Plans and Tr. Funds*, 133 S. Ct. 1184, 1199–1202, 1206 (2013).

192. *See, e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163–64 (2008); *Cent. Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 189 (1994); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975).

193. *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1318 (2015).

misleadingness under the test adopted would be “no small task” for plaintiffs.¹⁹⁴ Language in the decision actually goes so far as to suggest that the district court, in ruling on a motion to dismiss, should itself decide the materiality of the omitted facts alleged to have rendered an opinion misleading and, if it finds that they are material, decide whether a reasonable investor would have viewed the opinion as misleading in light of their omission.¹⁹⁵ While the Court cannot have meant this— instructing district courts to do anything more than determine whether reasonable minds could differ on these issues would upend a considerable body of well-established jurisprudence—the sloppy drafting reveals something about the Court’s collective mindset.

While the concerns that animate the materiality safety-valve doctrines are easy to understand, aggressive use of these doctrines is problematic. As explained in Section III.C, the practice contradicts the weight of Supreme Court precedent and thereby undermines the rule of law. Moreover, even if we interpret *Omnicare* as marking a shift in the Supreme Court’s stance, applying the reasonable investor standard based only on the pleadings is bad public policy. Judges, though more likely to own securities than the average juror, are similarly unlikely to apply the reasonable investor standard in a coherent and consistent way absent (a) a clear articulation of the reasonable investor’s identity and (b) the aid of expert testimony.¹⁹⁶

V. IMPLICATIONS FOR REFORM

The foregoing analysis suggests that the reasonable investor standard likely generates more uncertainty than the prototypical use of the reasonable person standard in the law of tort. Unlike in a simple tort case, juries cannot be relied upon to imbue the standard with an accepted social meaning. Rather, like in professional negligence cases, expert testimony must guide the fact-finder if principled decisions are to be rendered. But whereas the standard of care in professional negligence cases is defined by industry standards, sharpening the focus of expert testimony and providing better guidance to regulated parties, the identity of the reasonable investor remains opaque. The greater level of uncertainty that surrounds the reasonable investor standard is matched by the higher stakes that exist in

194. *Id.* at 1332.

195. *Omnicare* instructs that “on remand . . . *the court* must determine whether the omitted fact would have been material to a reasonable investor—i.e., whether ‘there is a substantial likelihood that a reasonable [investor] would consider it important.’” *Id.* at 1333 (emphasis added). If materiality is found, “*the court* must ask whether the alleged omission rendered *Omnicare*’s legal compliance opinions misleading . . . because the excluded fact shows that *Omnicare* lacked the basis for making those statements that a reasonable investor would expect.” *Id.* (emphasis added). The Court elaborated:

Insofar as the omitted fact at issue is the attorney’s warning, that inquiry entails consideration of such matters as the attorney’s status and expertise and other legal information available to *Omnicare* at the time. Further, the analysis of whether *Omnicare*’s opinion is misleading must address the statement’s context. That means *the court* must take account of whatever facts *Omnicare* did provide about legal compliance, as well as any other hedges, disclaimers, or qualifications it included in its registration statement. *The court* should consider, for example, the information *Omnicare* offered that States had initiated enforcement actions against drug manufacturers for giving rebates to pharmacies, that the Federal Government had expressed concerns about the practice, and that the relevant laws could be interpreted in the future in a manner that would harm *Omnicare*’s business.

Id. (emphases added).

196. See *supra* notes 128–133 and accompanying text.

securities class actions. Given this potent combination, it is not surprising that securities class actions that are not disposed of pretrial almost inevitably settle, and that judges in turn have taken it upon themselves to apply the reasonable investor test on the pleadings—notwithstanding their lack of authority or qualification.

It does not follow from the foregoing, however, that the switch to bright-line rules long advocated by critics of the reasonable investor standard is warranted. Such a move, while reducing over-deterrence costs, would likewise increase the risk of fraud by providing a path for companies to evade liability for intentionally misleading disclosures.¹⁹⁷ The net effects of this tradeoff would be impossible to measure or predict.¹⁹⁸ Nor would such reforms prove politically feasible. As detailed in Section III.C, the SEC and Supreme Court have repeatedly rejected proposed bright-line alternatives to the reasonable investor test, and their stance is unlikely to change in the future. Nor is Congress likely to conjure the political will to adopt a rule that could be characterized as offering firms a roadmap to commit fraud with impunity, even if motivated by legitimate concerns about over-deterrence.

Luckily, a switch to bright-line rules is not the only way to address the concerns raised by the reasonable investor test. As detailed below, more certain social welfare gains could likely be achieved through a different package of reforms that flow naturally from the analysis in Part IV.

A. Identify the Reasonable Investor

First, policymakers should resolve the unanswered questions regarding the identity of the reasonable investor. Whereas the ambiguity surrounding the identity of the reasonable person in a simple tort case serves a function, there is no justification for the ambiguity surrounding the identity of the reasonable investor. The latter should not be defined through the collective wisdom of a lay jury that has no knowledge about securities investing and no intuition about the normative goals of federal securities regulation. Nor should it be decided on an ad hoc basis by inexpert and unelected judges. Instead, it should be the studied focus of SEC rule-making or congressional legislation.

Better specifying the reasonable investor’s identity would work to reduce over-deterrence costs by making it easier for issuers to make and defend their disclosure choices. But, unlike the bright-line rules that have been repeatedly rejected by the SEC and Supreme Court, it would do so without undermining the flexibility of the reasonable investor standard and thereby creating a roadmap for fraud: fact-finders would still be required to consider all the facts and circumstances particular to the case at hand in judging materiality and misleadingness, they would just do so through a more carefully articulated lens. That lens would also serve to focus the presentation of expert evidence.

Identifying the reasonable investor is likely to be a politically uncomfortable task, as it will require that policymakers confront some difficult and long-avoided questions about

197. See *supra* note 110. Consider a materiality test that rendered any matter impacting revenue by less than 5% immaterial as a matter of law. Such a rule might save companies time and expense in the preparation of their disclosure documents. It might also reduce the level of noise in those documents, making them more useful to investors. But such a rule might also embolden companies to habitually overstate revenues by 4.99%, which would undermine the usefulness of corporate disclosures to investors.

198. See Couture, *supra* note 112, at 458–64 (discussing the trade-offs associated with altering the threshold for materiality).

the intended audience for the mandatory disclosures required by the federal securities laws. As Professor Langevoort has explained, “a fair amount of what the [SEC] does . . . is in the name of making disclosure ‘accessible’ to the average investor.”¹⁹⁹ “That sentiment,” he explains, “has led to the creation of an awkward myth-story” which envisions retail investors as “earnest and rational” consumers of corporate disclosures, engaged in the hard work of fundamental analysis.²⁰⁰ As explained in Part III.A, this image can be attacked as both descriptively inaccurate and normatively undesirable.²⁰¹ Not only that, but it cannot be reconciled with other aspects of federal securities regulation which build upon the insights of the efficient capital markets hypothesis (including the FOTM presumption of reliance that is key to class certification in many Rule 10b-5 cases). The efficient capital markets hypothesis implies that nonprofessionals should not read corporate disclosures because they cannot beat the market, and instead should act as passive price takers, building a well-diversified portfolio of securities to minimize risk.²⁰²

While confronting these existing tensions will be uncomfortable, there is reason to hope for progress. The SEC is currently overseeing a broad initiative to review disclosure rules for U.S. public companies.²⁰³ While the main goal of the initiative is to remove outdated or redundant disclosure requirements, the staff has recognized that the “audience for disclosure” is an important consideration in deciding what information should be required, and in which filings.²⁰⁴ It has therefore requested public comment on the question whether “registrants [should] assume some level of investor sophistication in preparing their disclosures” and, if so, what level of sophistication.²⁰⁵ The SEC staff has also asked the public “[t]o what extent should the reliance of certain investors on market prices or third-party analyses, rather than using disclosure directly, be a factor in determining the type of investor to which disclosures should be targeted?”²⁰⁶ Although the SEC staff has not drawn the connection explicitly, the relationship between these questions and the reasonable investor test is obvious.²⁰⁷

199. Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 173.

200. *Id.*

201. See *supra* notes 81–93 and accompanying text.

202. See *supra* note 85–86. Like the FOTM presumption of reliance, the SEC’s 2005 liberalization of the gun-jumping rules reflects a belief in the ECMH. See Securities Offering Reform, 70 Fed. Reg. 44,722, 44,726, 44,727 (Aug. 3, 2005) (to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, 274).

203. See, e.g., *Business and Financial Disclosure Required by Regulation S-K*, SEC Concept Release No. 33-10064, at 6 (Apr. 13, 2016), <https://www.sec.gov/rules/concept/2016/33-10064.pdf> (concept release seeking public comment “to assess whether [the business and financial disclosure requirements in Regulation S-K] continue to provide the information that investors need to make informed investment and voting decisions and whether any of our rules have become outdated or unnecessary”).

204. *Id.* at 14, 45–52.

205. *Id.* at 51.

206. *Id.* at 52.

207. As part of its current disclosure review initiative, the SEC staff has also sought commentary on whether to limit reliance on prescriptive disclosure requirements and to emphasize instead a principles-based approach. See *id.* at 44. Principles-based disclosure requirements leave it to companies to judge whether information is material and hence must be disclosed (e.g., “disclose any trends likely to have a material effect on operations”), whereas prescriptive disclosure requirements rely on bright-line tests rather than management’s judgment to determine when disclosure is required (e.g., “disclose all repurchases of equity”). See *id.* at 34–36. FASB is contemplating a similar move in the context of financial disclosures. See *Proposed ASU*, *supra* note 65 at 14. These changes would result in an even heavier reliance on the concept of materiality, and hence the reasonable investor, than exists currently.

Focusing on the target audience for challenged disclosures as a way to give flesh to the reasonable investor makes eminent sense. It also points out that the reasonable investor should not be given a monolithic identity, as target audiences will differ depending on the type of issuer. Many have argued, for example, that public company disclosures should be judged by reference to their effect on the market, as revealed through event studies when such studies are probative and by reference to the opinion of market professionals when they are not.²⁰⁸ Such an approach is justified, the argument goes, because non-professionals rarely read let alone rely on public company disclosures, nor should they.²⁰⁹ This argument has considerable force in the context of public operating companies, but it does not extend to public investment companies.²¹⁰ Non-professional investors do, or at least *should*, read their mutual fund’s disclosures, for example, just as they should listen to and rely upon the statements of their investment advisors.²¹¹ Thus, the identity of the reasonable investor should likely be conceived of differently in cases challenging such disclosures, as something closer perhaps to an average retail investor.²¹²

My objective here, however, is not to argue for particular definitions of the reasonable investor—that is a broad topic worthy of a separate paper, and about which much has

208. See *supra* note 82 and accompanying text. Event studies are probative only when the defendant company’s stock trades in an efficient market, and suffer from other limitations that may make them unsuitable in particular cases. See, e.g., Langevoort, *Taming the Animal Spirits*, *supra* note 81, at 177–78 (discussing some of the limitations of event studies, including complications that arise if suspicions about the truth are leaked out to the market over time, if other material events simultaneously affected the stock price, or if market prices under- or over-react to information, so that the adjustment time lengthens).

209. See *supra* notes 81–87 and accompanying text.

210. The SEC can make specific disclosure items material by simply by making them mandatory. See Roberta S. Karmel, *Disclosure Reform—The SEC is Riding Off in Two Directions at Once*, 71 BUS. L.W. 781, 786 (2016) (“The line-item disclosures of Regulation S-K are mandated and do not depend on an independent judgment by registrants as to their materiality.”); Victor Bradney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 727 (1989) (“The particular items of information mandated to be disclosed . . . are presumably automatically deemed to be ‘material.’”); Lee, *supra* note 64, at 670 (“Some courts have indicated that information required by . . . [SEC Regulations] may be material per se.”). Thus, even if the reasonable investor were defined by reference to a profit-oriented market, any mandated disclosures on nonpecuniary social issues would remain actionable by the SEC. See Karmel, *supra* note 210, at 790–816 (discussing examples of such disclosures).

211. See Langevoort, *Retail Investors*, *supra* note 83, at 1030 (noting that in the modern day, “retail investment decisions relate to investing in a mutual fund or insurance product, making retirement plan elections, or deferring to account management by a brokerage firm or investment adviser, rather than investing directly in issuers’ securities”).

212. Disclosures by private companies (including private investment companies) have yet another intended audience. Such offerings are often limited by law to “sophisticated” or “accredited investors” (see C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 622–24 (1996)), and the conception of the reasonable investor that applies in such cases ought to take this into account. Private company disclosures are different for another, more fundamental reason. In cases challenging such disclosures, plaintiffs generally must prove actual reliance, so class certification is not an option, and there is often a record of face-to-face dealings. These cases therefore tend to look much more like common law misrepresentation cases than modern securities class actions do, and a different approach to issues of materiality and misleadingness may therefore be warranted. For example, it may make sense to embrace the common law’s dual approach to materiality in such cases. That approach deems a matter material if a reasonable person would attach importance to it *or* if the plaintiff shows that the defendant knew or had reason to know that the plaintiff would regard the information as important. See *supra* note 33. This approach would ease the burden of proving materiality in cases brought against perpetrators of Ponzi schemes and affinity frauds, whose outlandish statements a reasonable investor, objectively defined, might disregard. See Sachs, *supra* note 76.

already been written.²¹³ Rather, it is simply to highlight the need for policymakers to develop *some* explicit definitions, preferably ones that fit with the regulatory goals of the federal securities laws and with market realities. This is a necessary first step to bring coherence to the reasonable investor standard.

B. Create an Early, But Evidence-Based, Decision Point

Even if the identity of the reasonable investor were better specified, however, application of the standard in particular cases would remain highly contextual. The reasonable investor test might therefore continue to generate a significant degree of uncertainty over the likely outcome of the issue at trial, creating intense settlement pressure in light of the high stakes involved in securities class actions. Lower courts might therefore continue to resort to the safety-valve doctrines discussed in Part III.C to decide the reasonable investor standard on the pleadings. As previously explained, these doctrines are undesirable because they disrespect the value of precedent. Moreover, even with a clearer image of the reasonable investor in mind, district court judges are unlikely to reach principled decisions applying the standard without the benefit of expert evidence. Defining the reasonable investor then, while a necessary first step, may not go far enough to improve the status quo.

One obvious response to this state of affairs would be to try to limit the lower courts' use of the safety-valve doctrines. But, assuming such a reform could be effectively implemented,²¹⁴ we would be left with the problem that has motivated resort to these doctrines in the first place: class action allegations implicating the reasonable investor standard would rarely be put to test, as pretrial resolution would be impossible except in the most implausible of cases and the uncertainty surrounding jury resolution would result in almost certain settlement. This would stunt the development of clarifying precedent and invite the filing of borderline cases. The over-deterrence costs that would be generated as a result, while difficult to quantify, are easy to imagine. If the choice is to either disclose a seemingly trivial piece of information or face a protracted securities class action for omitting what might in hindsight be considered a "material" fact, companies may err on the side of disclosure, bogging down what are already, many believe, overly-burdened filings. Conversely, if the choice is between saying nothing or facing a protracted securities class action for disclosing what in hindsight might be construed as a materially misleading half-truth, companies may err on the side of silence, depriving investors of potentially useful information. And on the margin, the threat of nuisance litigation might cause companies to forgo going public at all, or to avoid the U.S. capital markets.

Luckily, the choices available to policymakers are not so dichotomous. The reasonable investor test need not be decided on the pleadings or not at all. The analysis in Part IV suggests a middle way: Congress could create a decision point for application of the standard short of a trial on the merits, but one that permits the court to consider and weigh evidence. Like the safety-valve doctrines, such an approach would mitigate concerns about strike suits and the over-deterrence costs they generate by ensuring that issues of

213. For some contributions to this body of literature, see *supra* note 82; Huang, *supra* note 89; Sachs, *supra* note 76; Black, *supra* note 75. See also Couture, *supra* note 112, at 509–10 (summarizing arguments by various scholars).

214. This might prove tricky to police, as district courts must retain some discretion to dismiss complaints containing allegations so obviously unimportant to an investor that reasonable minds could not differ.

materiality and misleadingness are actually litigated, at least some of the time.²¹⁵ But the decisions on these issues would be informed by evidence, and would not flout the rule of law.

The most logical pretrial decision point for an evidence-based resolution of the reasonable investor test would be class certification. Congress could enact a statute, for example, expanding the list of certification criteria in cases brought under the federal securities laws to include, in addition to the requirements of Federal Rule of Civil Procedure 23, proof of a materially misleading statement, half-truth or omission. Such a statute would effectively supersede the outcome of the Supreme Court’s decision in *Amgen*,²¹⁶ but it would also go further. It would apply to *all* putative federal securities class actions, not just Rule 10b-5 cases seeking certification pursuant to the FOTM presumption of reliance. And it would cover both the element of materiality and the issue of misleadingness.²¹⁷ Tying application of the reasonable investor test to the decision on class certification is apt because it is the aggregation of claims via the class device that ratchets up the effects of the test’s uncertainty, fueling strike suit concerns. Moreover, judges are accustomed to weighing evidence and finding facts to ensure that the prerequisites to class certification have been met.²¹⁸

There are several predictable objections that may be raised to this proposal. Some will argue against it because it reassigned to the judge (at least preliminarily) what has historically been considered a jury issue.²¹⁹ But this raises no serious constitutional or policy concerns. The Seventh Amendment is not offended by judicial fact-finding on the prerequisites to class certification, even when the issues decided relate to the merits.²²⁰ This is because all that is at stake at class certification is the ability of the plaintiffs to access a procedural device²²¹: if certification is granted, it will remain open to the jury to

215. See Baker & Griffith, *supra* note 144, at 823–24 (arguing that more fact-based adjudication of securities claims would provide better guidance to future parties engaged in settlement negotiations, tying settlement closer to the merits).

216. The proposed statute would not, however, disturb *Amgen*’s interpretation of Rule 23’s predominance requirement.

217. As previously explained, both elements require application of the reasonable investor standard. See *supra* notes 66–73 and accompanying text.

218. See Wal-Mart Stores, Inc. v. Dukes, 564 U.S. 338, 350–52 (2011). By contrast, “on a motion for summary judgment, the district court may not weigh evidence or find facts.” Johnson v. Governor of Fla., 353 F.3d 1287, 1292 (11th Cir. 2003).

219. Securities law claims are entitled to a jury trial when legal remedies are sought. See James N. Benedict et al., *The Trial of a Securities Case: Selected Issues and Strategies*, in ALI-ABA Course of Study: SECURITIES LITIGATION PLANNING AND STRATEGIES SB93 (May 1997) (surveying cases on point).

220. This is the best reading of Seventh Amendment jurisprudence. See Richard Marcus, *Reviving Judicial Gatekeeping of Aggregation: Scrutinizing the Merits on Class Certification*, 79 GEO. WASH. L. REV. 324, 364–66 (2011); cf. Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J.L. REFORM 323, 357 (2010); Steig D. Olson, “Chipping Away”: *The Misguided Trend Toward Resolving Merits Disputes as Part of the Class Certification Calculus*, 43 U.S.F. L. REV. 935, 938 (2009). Of course, not all approve of the course that Seventh Amendment jurisprudence has taken. See generally Joshua P. Davis & Eric L. Cramer, *Antitrust, Class Certification, and the Politics of Procedure*, 17 GEO. MASON L. REV. 969 (2010); Suja A. Thomas, *Why the Motion to Dismiss is Now Unconstitutional*, 92 MINN. L. REV. 1851 (2008); Suja A. Thomas, *Why Summary Judgment Is Unconstitutional*, 93 VA. L. REV. 139 (2007).

221. Cf. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 87 (2006) (“[The presumption against preemption] carries less force here than in other contexts because SLUSA does not actually pre-empt any

decide the issue differently,²²² and if certification is denied, investors will retain their right to try the issue before a jury in an individual suit.²²³

From a policy standpoint, jury resolution of the reasonable investor standard has never been of much value. For one thing, jury resolution rarely ever occurs given the intense pressure that exists to settle before trial.²²⁴ Second and more fundamentally, the jury in a securities class action is not called upon to serve the important function that the jury serves in a simple tort case. Recall that in a simple tort case the jury is meant to channel the conscience of the community in rendering its decision and thereby to legitimize the otherwise content-less reasonable person standard; in a securities class action, by contrast, application of the reasonable investor standard should usually be judged by reference to expert testimony.²²⁵ Juries are not obviously better equipped to evaluate expert testimony than judges; to the contrary, many believe judges have the advantage by virtue of their advanced education and experience.²²⁶

Critics are also likely to point to the costs the proposed statute would generate. This is a more serious concern. Requiring the reasonable investor test to be adjudicated in a mini-trial at class certification would require the ongoing expenditure of judicial resources. In addition, it would operate to increase the costs plaintiffs' lawyers must incur to get cases to a settlement posture, which may discourage filings on the margins. To the extent the marginal cases discouraged involve allegations of materiality or misleadingness that cannot be supported by evidence, the reform will simply have achieved its purpose; but it is possible that some meritorious cases might also be discouraged, undermining the deterrence potential of private securities litigation. How significant these potential costs

state cause of action. It simply denies plaintiffs the right to use the class-action device to vindicate certain claims. The Act does not deny any individual plaintiff . . . the right to enforce any state-law cause of action that may exist.”).

222. *Dukes*, 564 U.S. at 351 n.6.

223. *Smith v. Bayer Corp.*, 564 U.S. 299, 315 (2011); *Amgen Inc. v. Conn. Ret. Plans and Tr. Funds*, 133 S. Ct. 1184, 1201 (2013). Even when the judge’s decision would strip the plaintiff of its right to put the issue before a jury—which again is *not* a possibility under the proposed statute—some courts have held that judicial fact-finding on matters that overlap with the merits does not offend the Seventh Amendment if necessary to decide issues of “judicial traffic control.” *Pavey v. Conley*, 544 F.3d 739, 741–42 (7th Cir. 2008) (en banc).

224. See *supra* note 30.

225. See *supra* notes 163–172 and accompanying text.

226. See *supra* note 49. The Supreme Court’s seminal patent decision in *Markman v. Westview Instruments*, 517 U.S. 370 (1996), is instructive. Patent claims must be construed from the perspective of a “person having ordinary skill in the art” (PHOSITA). Even though how a PHOSITA would construe a patent cannot typically be judged without the benefit of expert testimony, *Markman* held that the task of patent claim construction is for the court, not the jury. “[T]he construction of written instruments is one of those things that judges often do and are likely to do better than jurors unburdened by training in exegesis,” the Court explained. *Id.* at 388. Although “credibility judgments have to be made about the experts who testify in patent cases, and in theory there could be a case in which a simple credibility judgment would suffice to choose between experts whose testimony was equally consistent with a patent’s internal logic,” the Court explained that this would be a rare situation:

In the main, we expect, any credibility determinations will be subsumed within the necessarily sophisticated analysis of the whole document, required by the standard construction rule that a term can be defined only in a way that comports with the instrument as a whole. Thus, in these cases a jury’s capabilities to evaluate demeanor, to sense the “mainsprings of human conduct,” or to reflect community standards, are much less significant than a trained ability to evaluate the testimony in relation to the overall structure of the patent.

Id. at 389–90 (internal citations omitted).

would be, and whether they would outweigh the potential benefits of the proposed statute, are difficult empirical questions. Reasonable people may have different intuitions as to the answers.²²⁷ A few considerations, however, give cause for optimism.

First, although applying the reasonable investor standard at class certification would impose a new burden on the judiciary, it would at the same time save judicial resources if it succeeds in reducing the number of borderline cases that are filed. The net costs imposed on the judiciary would depend on these relative impacts.

Second, although the proposed statute might increase the costs imposed on plaintiffs' lawyers and thereby discourage the filing of some meritorious cases, it might also result in fewer dismissals of meritorious cases based on the safety-valve doctrines. District courts might be less inclined to resort to these doctrines, once the option to decide materiality at class certification is made available. By weeding out non-meritorious cases, the proposed reform should also increase the reputational consequences of the class actions that do survive to settlement. Any assessment of the impact of the reform on the deterrence potential of private securities litigation would need to take all of these effects into account.

Third and most importantly, the statute could be written in a way that dramatically minimizes its costs. Specifically, instead of requiring plaintiffs to prove a materially misleading statement, half-truth or omission in every case in order to achieve class certification, the statute could simply permit defendants to *rebut* the certifiability of the class by presenting proof of their absence. Thus, only in a subset of cases where defendants felt confident in their ability to prevail on these issues would plaintiffs be called upon to litigate them. This would not only minimize the impact of the reform on the incentive for plaintiffs to bring meritorious cases, it also would reduce the burden on the judiciary, because mini-trials would be a feature in fewer cases.

Putting the onus on defendants to disprove these issues at class certification would take a play from the Court's recent decision in *Halliburton Co. v. Eric P. John Funds, Inc.*²²⁸ In *Halliburton*, the Court held that while a plaintiff is not required to present proof of a misrepresentation's impact on a securities' market price in order to achieve class certification in a case invoking the FOTM presumption of reliance, defendants have a right to present evidence rebutting price impact in order to defeat class certification.²²⁹ Notably, *Halliburton* does not appear to have significantly depressed securities class action filings—to the contrary, filings this year are on pace to be the highest since the enactment of the PSLRA.²³⁰ It is also telling that defendants do not appear to be presenting evidence to rebut price impact in every case. This makes sense: doing so and failing would negatively affect

227. The deterrence potential of private securities litigation is hotly debated. See generally Amanda M. Rose, *Better Bounty Hunting: How the SEC's New Whistleblower Program Changes the Securities Fraud Class Action Debate*, 108 Nw. U.L. Rev. 1235, 1245–60 (2014).

228. *Halliburton Co. v. Eric P. John Funds, Inc.*, 134 S. Ct. 2398 (2014).

229. *Id.* at 2414. The proposed statute would have the ancillary benefit of alleviating current judicial confusion over the interaction between *Halliburton* and *Amgen*. Some courts have refused to consider defense evidence proffered at class certification to disprove price impact (an issue that *Halliburton* teaches may be litigated at class certification) when it also speaks to materiality (an issue *Amgen* teaches may not be litigated at class certification). See, e.g., *Food Employees Welfare Fund v. Regions Financial Corp.*, 2014 WL 6661918, at 8–10 (N.D. Ala. Nov. 19, 2014); *Aranaz v. Catalyst Pharmaceutical Partners, Inc.*, 302 F.R.D. 657, 670 (S.D. Fla. Sept. 29, 2014).

230. See CORNERSTONE RES., *supra* note 30, at 1.

the defendant's posture in subsequent settlement negotiations.²³¹

Another line of attack might challenge the scope of the proposal. Why, one might ask, stop at the reasonable investor test? Why not instead allow the court to conduct a full merits review at class certification, considering, for example, issues of scienter, loss causation and damages in Rule 10b-5 suits?²³² The problem with such an approach becomes apparent if one thinks through its incentive effects. If the court considered the full merits of the case at class certification, and granted the certification motion, the defendant's position in subsequent settlement negotiations would be incredibly weak. And if the court denied class certification, the plaintiff would have no leverage to demand any settlement at all. Essentially, litigating class certification would be akin to taking the case to trial, an extremely expensive gamble that neither side wants to take. The predictable result would be that the parties would reach a settlement agreement earlier in the process and then move for certification of a settlement class. It would be quite odd to call on the court to decide the merits of the case at that point, given that the parties would lack any further adversarial interest. The better approach would be to hinge class certification on proof—or, better yet, to hinge denial of certification on *disproof*—of a materially misleading misstatement, half-truth or omission, and to leave the other elements of the plaintiffs' case on the table for the parties to debate in subsequent settlement negotiations, should the case move forward.²³³

To be sure, alternative reforms designed to achieve similar ends could be imagined. For example, comparable concerns have led numerous states to adopt laws subjecting medical malpractice claims to screening by an expert panel prior to filing in court.²³⁴ One could imagine asking the SEC to serve a similar screening function in connection with securities class actions (indeed, I proposed precisely this in a 2008 article²³⁵). Or Congress could authorize the use of blue ribbon juries in securities class actions as a way to entice companies to take more cases to trial, something that has been suggested in the patent context.²³⁶ One advantage of the proposed statute over these alternatives is political

231. See Press Release, Beazley, *Halliburton Ramifications* (June 23, 2014), https://www.beazley.com/news/2014/halliburton_ramifications.html (observing that “where a defendant tries but fails to demonstrate the absence of price impact, including where a study rebuts some but not all of the evidence of artificial price inflation, the potential settlement value of a case could increase significantly”). This highlights another advantage of the proposed statute relative to the safety-valve doctrines that are used so frequently today. Unlike the latter, judicial application of the reasonable investor test at class certification would not work to the exclusive benefit of the defense. When courts reject defense arguments at the motion to dismiss or summary judgment phase, they simply hold that the issue must be reserved for jury resolution at trial, without necessarily indicating that the plaintiffs have a strong position. But under this proposal, if the reasonable investor test is litigated at class certification, and plaintiffs prevail in getting the case certified, the court will have necessarily found that plaintiffs have met their burden to establish a materially misleading misstatement or omission. Though not preclusive in a subsequent class trial, this would substantially bolster the plaintiffs’ settlement posture.

232. Professors Bone & Evans have argued that a similar approach should be taken to *all* class actions. See Bone & Evans, *supra* note 144 at 1327–29 (arguing that class action law should be reformed to permit certification only if the court determines the plaintiff has a significant likelihood of success on the merits).

233. It is appropriate to privilege issues for decision at class certification that require application of the reasonable investor test, given the high level of uncertainty that surrounds the test and the far reaching effects it has on issuer disclosure choices.

234. See Heather Morton, *Medical Liability/Malpractice ADR and Screening Panels Statutes*, NAT'L CONF. OF ST. LEGISLATURES (May 20, 2014), <http://www.ncsl.org/research/financial-services-and-commerce/medical-liability-malpractice-adr-and-screening-panels-statutes.aspx>.

235. See Rose, *Reforming Securities Litigation Reform*, *supra* note 8, at 1354.

236. See, e.g., Jordan M. Halle, *Avoiding Those Wearing Propeller Hats: The Use of Blue Ribbon Juries in Complex Patent Litigation*, 43 U. BALT. L. REV. 435 (2014).

feasibility: because the statute would work a fairly modest change to the current securities litigation landscape, it stands a better chance of implementation. The proposed statute would also likely prove more effective—the SEC might shy away from exercising its screening power in a rigorous way, and companies may not be willing to roll the dice at trial even if promised a more competent jury. But my goal here is not to prove that the proposed statute is the only or even the best reform that might be adopted to address concerns raised by use of the reasonable investor test. Rather, it is simply offered as one attractive way that policymakers might improve the status quo—a way that, unlike the bright-line rules that have been advanced in the past, does not offer companies a roadmap for fraud.

VI. CONCLUSION

For decades the reasonable investor test has been a flashpoint for debate in securities law circles. That debate has proven incredibly persistent in large part because it has been framed as a question of rules vs. standards—with critics of the reasonable investor test complaining of the uncertainty it generates and defenders warning of the under-inclusiveness of the bright-line rules offered as alternatives. This Article has attempted to shed fresh light on the issue by considering how the reasonable investor differs from its common law antecedent, the reasonable person of tort law. The comparative analysis undertaken suggests new and promising avenues of reform that are worthy of consideration by policymakers.