

# An Inquiry into the Perception of Materiality as an Element of Scierter Under SEC Rule 10b-5

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*In any private action or enforcement proceeding based on SEC Rule 10b-5 the plaintiff, including the Securities and Exchange Commission, must prove that the defendant engaged in deception or manipulation with scierter, that is, an intent to deceive, which lower courts have held encompasses reckless conduct. Where the gravamen of the claim is deception, the deception must have been material. A fact, including forward-looking information, is material if there is a substantial likelihood that a reasonable shareholder would consider the fact important in making his investment decision. This article demonstrates that in an appropriate case an assessment of whether the defendant acted with scierter should consider whether the defendant appreciated the materiality of an omitted or misrepresented fact. For example, an insider who traded in the securities of his employer while he was aware of nonpublic information should not be found to have acted with scierter, if, before trading, he made a good-faith evaluation of that information, including (but not necessarily) consulting with counsel, and concluded that the information was not material, even though a trier of fact later found that the information was material when the trade occurred.*

An essential element of a claim under Securities and Exchange Commission (“SEC” or “Commission”) Rule 10b-5<sup>1</sup> is that the defendant acted with scierter.<sup>2</sup> A much-litigated issue in private suits for damages based on a violation of Rule 10b-5 is whether the plaintiff has adequately pleaded the defendant’s scierter. Scierter is also often contested in those comparatively few cases that reach the summary judgment or trial stage. Scierter is similarly at the core of actions by the

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1. 17 C.F.R. § 240.10b-5 (2011), which was adopted by the SEC pursuant to section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. § 78j(b) (2006 & Supp. IV 2010).

2. “In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scierter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.” *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008). Where they are elements of the cause of action these elements must also be pleaded. See *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318 (2011) (referring to need to plead material misrepresentation or omission and scierter); *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 346 (2005) (referring to need to plead loss causation and economic loss).

SEC to seek a remedy for violations of that rule and by the Department of Justice to prosecute violations.<sup>3</sup> One often-overlooked issue is the extent to which a defendant's appreciation of the materiality of the deception that lies at the heart of the claim bears on his scienter.<sup>4</sup> A scienter-focused analysis of a defendant's consideration of whether a fact is material is more likely to be pertinent when the defendant is alleged to have failed, with scienter, to disclose a fact rather than when he affirmatively misrepresented a fact.<sup>5</sup> There are some situations where omissions are actionable when no other statement is made, such as insider trading.<sup>6</sup> In other cases, the omission is wrongful because the failure to disclose caused a statement that was made to be materially incomplete, sometimes called a "half-truth."<sup>7</sup> Because scienter is an element of every claim under Rule 10b-5, an analysis of the

3. Reliance and loss causation need not be established in an SEC enforcement proceeding or criminal prosecution for a violation of Rule 10b-5; the materiality of the deception and the defendant's scienter remain elements of a civil or criminal enforcement claim. DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, *SECURITIES LITIGATION AND ENFORCEMENT CASES AND MATERIALS* 149 (3d ed. 2012).

4. More than a decade ago, I published an analysis of the relevance in a Rule 10b-5 private damage or government enforcement action of the defendant's consciousness of the materiality of his alleged non-disclosure or misrepresentation. Allan Horwich, *The Neglected Relationship of Materiality and Recklessness in Actions Under Rule 10b-5*, 55 *BUS. LAW.* 1023 (2000). The thesis of that article was that

where a defendant is charged with recklessly misrepresenting or failing to disclose a material fact, the assessment of recklessness necessarily entails an evaluation of whether the defendant appreciated, or was reckless in not appreciating, the materiality of the fact. To put the issue in the form of a question: is a speaker reckless when he fails to disclose a fact that he knows if he does not recognize it to be material, or negligently concludes that it is not material?

*Id.* at 1023–24. While others have since addressed the relationship of scienter and materiality (see *infra* text accompanying notes 31–34 for one article), they have not done so from the perspective of the defendant's actual assessment of materiality at the time of the event giving rise to the claim. See Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort, *Fraud by Hindsight*, 98 *Nw. U. L. REV.* 773, 791 (2004) ("As a practical matter, the objective/subjective distinction between materiality and scienter is artificial. Plaintiffs generally do not have direct evidence going to the defendant's subjective state of mind at the motion to dismiss stage. The question on scienter thus becomes whether the information in question was so obviously important to investors that the failure to disclose it constituted severe recklessness. That articulation of scienter is merely a heightened level of materiality: the information was so obviously important, which is scienter, as opposed to important, which is materiality."); see also Clarissa S. Hodges, *The Qualitative Considerations of Materiality: The Emerging Relationship Between Materiality and Scienter*, 30 *SEC. REG. L.J.* 4, 20 (2002) (discussing the extent to which scienter is to be taken into account in determining the materiality of a quantitatively small misstatement). By contrast, a recent extensive examination of the issue of culpability in actions under Rule 10b-5 addressed the issue of the defendant's awareness of the falsity of information, with no discussion of the relevance of the awareness of the materiality of that falsity. Samuel W. Buell, *What Is Securities Fraud?*, 61 *DUKE L.J.* 511 (2011).

5. It seems unlikely that a defendant would have knowingly affirmatively misrepresented a fact but proceeded to do so with the comfort that his incorrect (rather than incomplete) statement was *immaterially* false. Nevertheless, the thesis advanced in this article might apply to that situation.

6. *United States v. O'Hagan*, 521 U.S. 642, 651–52 (1997) (describing classical theory of insider trading where corporate insider may have duty to disclose material nonpublic information before trading).

7. SEC Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (2011), renders it unlawful "to omit to state a material fact necessary in order to make the statements made . . . not misleading." Identifying the circumstances when the failure to disclose violates Rule 10b-5 was recently analyzed in Todd R. Davis & Lisa A. Begni, *When Is Silence Fraudulent?*, *LAW 360* (Feb. 7, 2011, 2:19 PM EST), [http://www.law360.com/securities/articles/223288?utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=securities](http://www.law360.com/securities/articles/223288?utm_source=newsletter&utm_medium=email&utm_campaign=securities), in which some of the cases analyzed later were discussed.

relationship between scienter and materiality applies across the entire spectrum of Rule 10b-5 litigation.<sup>8</sup>

The vitality of this issue is demonstrated by three very recent cases. In *Matrixx*, which addressed the sufficiency of scienter and materiality allegations in a complaint for damages, the Supreme Court observed that the defendants could seek to rebut evidence of scienter at trial with proof that they had made a good-faith judgment not to disclose the information in question because they believed it was not material.<sup>9</sup> More recently, the U.S. Court of Appeals for the Eighth Circuit held that scienter had not been pleaded because, among other factors, the complaint alleged that the corporate defendant's president had explained that he had not disclosed a recent development because he did not think it was material.<sup>10</sup> Still more recently, a district court dismissed a complaint where the facts alleged reflected that the corporate employee, whose conduct allegedly provided the basis for the corporation's scienter, did not appreciate, and could not have been expected to appreciate, that her conduct would lead to a material financial misstatement.<sup>11</sup>

This article begins with a discussion of the core concepts of scienter and materiality, which demonstrates why the issues are related. It then turns to a discussion of the cases that have recognized the relationship of these fundamental concepts<sup>12</sup> and other instructive sources.

## I. THE LAW OF SCIENTER UNDER RULE 10b-5

In order to state a cause of action under Rule 10b-5, whether a private suit for damages or a civil or criminal enforcement action, the plaintiff must establish that the defendant acted with scienter, which is a "mental state embracing intent to deceive, manipulate, or defraud."<sup>13</sup> A specific intent to violate Rule 10b-5 is not

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8. As explained later, the pleading and proof requirements for scienter differ depending upon the nature of the plaintiff—a private party seeking damages, the SEC seeking an enforcement remedy, or the United States in a criminal prosecution. See *infra* text accompanying notes 13–16. The burden of proof in private damage cases and enforcement cases is the same, preponderance of the evidence. An analysis of how a defendant may rebut proof of scienter that is based on those cases would have an *a fortiori* impact on criminal cases, which have a higher threshold of proof. Accordingly, there has been no effort to separate the discussions of the different types of cases.

9. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1325 (2011). This aspect of the decision is addressed in more detail at *infra* text accompanying notes 114–19.

10. *Minneapolis Firefighters' Relief Ass'n v. MEMC Elec. Materials, Inc.*, 641 F.3d 1023, 1030 (8th Cir. 2011). This decision is addressed in more detail at *infra* text accompanying notes 127–30.

11. *Rains v. Zale Corp.*, Nos. 3:09-CV-2133-B, 3:09-CV-2218-B, 3:09-CV-2133-B, 2011 WL 3331213, at \*5 (N.D. Tex. Aug. 1, 2011), *appeal docketed*, No. 11-10936 (5th Cir. Oct. 4, 2011). This decision is described in more detail at *infra* text accompanying notes 131–35.

12. For the discussion of the cases that expressly, or strongly by inference, address this relationship, see *infra* text accompanying notes 97–135. A reader who wishes to begin with these cases, which do not contain much underlying analysis of this issue, and then return to the development of the thesis should proceed to the later discussion and then return to Part I.

13. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976) (private action for damages); *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (SEC enforcement action).

an essential element of scienter.<sup>14</sup> To establish a criminal violation of Rule 10b-5, the prosecution must prove that the defendant “willfully” violated the provision.<sup>15</sup> Here, too, there is no requirement to prove that the defendant had a specific intent to violate the law.<sup>16</sup>

The Supreme Court has never decided whether scienter encompasses reckless conduct; it has repeatedly expressly reserved the question for thirty-five years.<sup>17</sup> After *Hochfelder*, however, the courts of appeals uniformly have held that scienter includes reckless conduct.<sup>18</sup>

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14. *Pittsburgh Terminal Corp. v. Balt. & Ohio R.R. Co.*, 680 F.2d 933, 942 (3d Cir. 1982) (holding that violation of Rule 10b-5 can be established without a showing of a specific intent to violate the law); *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 77 (D.C. Cir. 1980) (“Except in very rare instances, no area of the law—not even the criminal law—demands that a defendant have thought his actions were illegal.”).

15. See, e.g., *United States v. Tarallo*, 380 F.3d 1174, 1188 (9th Cir. 2004) (“‘willfully’ as it is used in [15 U.S.C.] § 78ff(a) [the criminal sanction provision of the Exchange Act] means intentionally undertaking an act that one knows to be wrongful; ‘willfully’ in this context does not require that the actor know specifically that the conduct was unlawful”).

16. *United States v. Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976).

17. See, e.g., *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1323–24 (2011) (“we assume, without deciding, that the [recklessness] standard applied by the Court of Appeals is sufficient to establish scienter” (footnote omitted)); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007) (reserving question); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.4 (1983) (same); *Hochfelder*, 425 U.S. at 193 n.12 (same).

*Tellabs* addressed the heightened standard for pleading scienter in a private cause of action for damages added to the Exchange Act by section 101 of the Private Securities Litigation Reform Act of 1995 (“PSLRA”), Pub. L. No. 104-67, 109 Stat. 737, 747. That provision became section 21D(b)(2) of the Exchange Act, 15 U.S.C. § 78u-4(b)(2) (2006 & Supp. IV 2010). It was renumbered section 21D(b)(2)(A) by section 933(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1883 (2010) (“Dodd-Frank”). The heightened standard requires that in a private action under the Exchange Act for money damages that may be maintained “only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate [the Exchange Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2)(A). By its express terms (“[i]n any private action”), this pleading standard does not apply in an SEC enforcement action under Rule 10b-5. *SEC v. Steffes*, No. 10-CV-6266, 2011 WL 3418305, at \*13 (N.D. Ill. Aug. 3, 2011) (discussing prior cases that have addressed the issue).

It is generally agreed that the imposition of the heightened pleading requirement when alleging “a particular state of mind” in a private cause of action under Rule 10b-5 did not change the “required state of mind,” viz., scienter. MICHAEL A. PERINO, SECURITIES LITIGATION UNDER THE PSLRA § 3.02, at 3-150 to -151 (2012) (“The PSLRA clearly does not purport to alter the general state of mind requirements of a Rule 10b-5 action. . . . The ‘strong inference’ [pleading] standard does not alter Rule 10b-5’s substantive scienter requirement.”).

The heightened pleading standard for scienter also does not change the burden of proof on the merits in a private action for damages, which is a preponderance of the evidence. *Tellabs*, 551 U.S. at 328–29; see also *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 535 (S.D.N.Y. 2011) (applying standard of preponderance of the evidence in ruling on defendant’s motions for judgment as a matter of law or for new trial in action under Rule 10b-5). In deciding a motion for summary judgment some courts have applied the *Tellabs* interpretation of the “strong inference” requirement. See, e.g., *Nolvi v. Ohio Ky. Oil Corp.*, 562 F. Supp. 2d 904, 910 (N.D. Ohio 2008) (“[*Tellabs* and other cited cases] deal with the pleading standard required for these claims, but [the court] finds that the underlying rationale is applicable to the summary judgment setting as well.”). Whether this application of *Tellabs* is appropriate is beyond the scope of this article.

18. See *Tellabs*, 551 U.S. at 319 n.3 (“Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required.”).

A long-accepted definition of reckless conduct in this context is

a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.<sup>19</sup>

Many courts currently apply this standard of recklessness.<sup>20</sup> A recent survey of the different expressions of reckless conduct sufficient to satisfy Rule 10b-5 concluded that in the end they essentially state what *Sundstrand* held.<sup>21</sup> When a private damage complaint under Rule 10b-5 does not adequately plead scienter, the case is dismissed, with no opportunity for discovery to develop more facts to shore up the deficient scienter allegations, much less proceed to a disposition on the merits.<sup>22</sup>

In the seminal *Sundstrand* decision, the court elaborated that to be reckless a failure of disclosure “must derive from something more egregious than even ‘white heart/empty head’ good faith.”<sup>23</sup> The court explained that “if a trial judge found, for example, that a defendant genuinely forgot to disclose information or that it never came to his mind, etc., this prong of the [recklessness test] would defeat a finding of recklessness even though the proverbial ‘reasonable man’ would never

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19. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976), *vacated on other grounds*, 619 F.2d 856 (10th Cir. 1980)). This is the “most widely followed approach” to defining recklessness for these purposes.” 8 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3688 (3d ed. 2004). (This statement has been retained into 2011 without change.)

20. *See, e.g.*, *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp.*, 632 F.3d 751, 757 (1st Cir. 2011) (quoting *Sundstrand* definition of recklessness); *Gebhart v. SEC*, 595 F.3d 1034, 1041–42 (9th Cir. 2010) (holding that reckless conduct that constitutes scienter is an extreme departure from the standards of ordinary care which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it); *S. Cherry St., LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (same); *Flaherty & Crumrine Preferred Income Fund Inc. v. TXU Corp.*, 565 F.3d 200, 207 (5th Cir. 2009) (same); *Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 267 n.42 (3d Cir. 2009) (same).

Some courts apply a higher standard of recklessness as a threshold of liability where the defendant is an outside auditor:

[T]he meaning of recklessness in securities fraud cases is especially stringent when the claim is brought against an outside auditor. . . . Recklessness on the part of an independent auditor entails a mental state so culpable that it approximate[s] an actual intent to aid in the fraud being perpetrated by the audited company. . . . Scienter requires more than a misapplication of accounting principles. The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.

*PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 693–94 (6th Cir. 2004) (internal quotations and citations omitted).

21. Ann Morales Olazábal, *Defining Recklessness: A Doctrinal Approach to Deterrence of Secondary Market Securities Fraud*, 2010 WIS. L. REV. 1415, 1424–25, 1442–43.

22. *See* Exchange Act § 21D(b)(3)(A)–(B), 15 U.S.C. § 78u-4(b)(3)(A)–(B) (2006) (providing that any private action arising under the Exchange Act shall be dismissed if it fails to allege the requisite state of mind as required by section 21D(b)(2)(A) and that pending any motion to dismiss on that ground discovery shall be stayed, subject to narrow exceptions); PERINO, *supra* note 17, § 3.01E (describing the effect of failure to satisfy the pleading requirements) & ch. 4 (explaining the discovery stay).

23. *Sundstrand*, 553 F.2d at 1045 (footnote omitted).

have forgotten.”<sup>24</sup> This interpretation of the test is still applied, at least in the Seventh and Ninth Circuits.<sup>25</sup>

The essential component of a risk that is known or obvious, created by a misrepresentation or omission,<sup>26</sup> presents alternative formulations—what is actually known or what is obvious. *Sundstrand* stated that the test for recklessness was an “objective” one,<sup>27</sup> but in fact application of the test sometimes entails an inquiry into what the defendant actually knew or thought, as shown in cases that have directly addressed the relevance of materiality to scienter.<sup>28</sup> This is especially so because the test depends not only on knowledge of the *facts* that create the risk, but, crucially, actual or imputed appreciation of the *risk* itself—it is only where the “danger of misleading” is known or sufficiently “obvious” that the defendant acts recklessly. This depends upon the potential *impact* (“misleading”) of the faulty disclosure *on investors*, which in turn depends on the materiality of the information.<sup>29</sup> That is, whether there is a risk of misleading—the investor would have assessed his decision differently, albeit not necessarily changed his mind—depends on whether there was a substantial likelihood that a reasonable shareholder would have considered the omitted or misstated information important in making his investment decision.<sup>30</sup> This article asserts both that a proper understanding of an “intent to deceive” includes consideration of the defendant’s actual state of mind and that even in imputing a perception of obviousness for the purpose of applying the recklessness standard, an analysis of the defendant’s own real-time assessment of the risk of deception, i.e., the materiality, is appropriate.

One recent commentator found the jurisprudence of recklessness under Rule 10b-5 to be “rudderless.”<sup>31</sup> She proposed an approach that would infer recklessness

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24. *Id.* at 1045 n.20. It is not clear whether that court would exonerate someone who cavalierly overlooked patently significant information. This article does not argue that there would be no scienter in that situation. It is argued here, however, that forgetting or overlooking information because the defendant had genuinely never considered it to be important should be taken into account in assessing whether the defendant was reckless.

25. See *SEC v. Platforms Wireless Int’l Corp.*, 617 F.3d 1072, 1093 (9th Cir. 2010); *ABN AMRO, Inc. v. Capital Int’l Ltd.*, 595 F. Supp. 2d 805, 842 (N.D. Ill. 2008).

26. The cause of the risk of misleading an investor can cover the gamut of deception in violation of Rule 10b-5, such as a misrepresentation or an omission, including the failure to disclose a contingency relevant to a forward-looking statement. A comprehensive discussion of the nature of deception that may violate Rule 10b-5 is beyond the scope of this article. See also *infra* note 89.

27. *Sundstrand*, 553 F.2d at 1045; see Michael J. Kaufman & John M. Wunderlich, *Messy Mental Markers: Inferring Scienter from Core Operations in Securities Fraud Litigation* 12 (Loyola Univ. Chi. Sch. of Law Research Paper No. 2011-017, 2011), <http://ssrn.com/abstract=1885650> (“The objective obviousness of the danger of misleading statements is sufficient for liability alone, even if the defendant does not actually appreciate that risk.” (footnote citing *Sundstrand* omitted)). A major thesis of the present article rejects that conclusion, which was presented in the cited article without development.

28. See *infra* text accompanying notes 121–30.

29. See *infra* text accompanying notes 46–54.

30. This is the core definition of materiality. See *infra* text accompanying notes 46–47.

31. Olazábal, *supra* note 21, at 1421. See *id.* at 1421–29 and 1442–45 for a general discussion of the law of recklessness under Rule 10b-5. Professor Olazábal makes clear that her proposal applies only to the pleading stage in a private action for damages. *Id.* at 1455 (“[T]he analysis I promote here applies at the pleading stage. It provides a more principled definition of recklessness for purposes of determining whether a ‘strong inference’ of scienter can be drawn from the facts set forth in a class action fraud-on-the-market complaint.”).

at the pleading stage in order to determine whether a private complaint for damages “state[s] with particularity facts giving rise to a strong inference that the defendant” acted with scierter.<sup>32</sup> The proposal is that

in suits involving putative false statements by officers, upon a motion to dismiss three contextual factors can establish and limit inferences of an officer’s recklessness available. These factors are the *magnitude*, atypicality, and timing of the misinformation or its disclosure. Put otherwise, my thesis is that while no officer is expected to, nor can she, know every detail about a large publicly traded corporation, it is the epitome of recklessness for a highly paid corporate head to speak to the market about *important corporate matters* without knowing the truth. Hence, when pleading a circumstantial case of recklessness against a high-ranking corporate executive, a complaint that identifies the truth—placing it in the relevant corporate context—can establish a cogent and compelling inference that the true fact misrepresented was *so important* that the officer was either reckless in failing to know it or reckless in speaking about it without knowing.<sup>33</sup>

Under this approach the inference of scierter may not be appropriate where the materiality of the information was uncertain or borderline.<sup>34</sup> Thus, whether to infer scierter, at least at the pleading stage, would be driven in part by the significance of the information. I part company with Professor Olazábal principally in concluding that *the defendant’s own conception* of the materiality of omitted facts is a factor to be weighed in the recklessness analysis, while recognizing that in cases where the materiality is effectively indisputable the defendant’s claim that he did not think the information was material may not be credible.

It would be an unusual case where the plaintiff would know facts regarding the defendant’s actual consideration of the materiality of undisclosed information and would choose to plead them.<sup>35</sup> Thus, the defendant’s conscious consideration of the materiality of an omitted fact is far more likely to be addressed on the merits. As discussed earlier, at the merits stage in private actions for damages the heightened scierter pleading standard imposed by the PSLRA does not apply.<sup>36</sup> The defendant’s evidence of his consideration of the materiality of information, and any related assessment by him of the risk that a non-disclosure could entail, could

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32. See *supra* note 17 (describing the heightened standard for pleading scierter in private actions for damages).

33. Olazábal, *supra* note 21, at 1419–20 (emphasis added) (footnote omitted). While Professor Olazábal’s article speaks almost exclusively about misrepresentations, nothing in her analysis suggests it would not apply equally to the omission of material facts by a corporate executive who would be expected to know “important corporate matters.” Indeed, in the corporate disclosure context, which is the focus of her discussion, questions of omissions tend to arise in the context of an alleged half-truth, the failure to disclose “a material fact necessary in order to make the statements made . . . not misleading.” Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (2011). See *supra* note 7.

34. The author stated, “On the other side of that coin, misrepresented numbers or facts that are trivial in proportion to the company’s overall revenues, illegal practices that are small in scope, or matters that would otherwise be deemed immaterial, are probably not within the realm of what we can or should expect a CEO or CFO to know with any certainty.” *Id.* at 1433 (footnote omitted).

35. For two cases where there were allegations before the court on a motion to dismiss that allowed the court to assess the defendants’ thought process, see *infra* text accompanying notes 123–30.

36. See *supra* note 17.

be presented through his own testimony, contemporaneous documents prepared by him, and possibly persons with whom he spoke when contemplating the disclosure decision.

There is a line of cases, sometimes referring to a company's "core operations," where, at least at the pleading stage, there is attribution to senior management of knowledge of omitted or misrepresented information because the facts are "so important to the company" that the defendants must have been aware of them.<sup>37</sup> This applies, however, only where the facts are "so important," not where the materiality is less clear.<sup>38</sup> The core operations doctrine has not proven to be a cure-all for plaintiffs, as it often fails to provide the basis for satisfying the heightened scienter pleading standard.<sup>39</sup>

The decision of the U.S. Court of Appeals for the Seventh Circuit on the Supreme Court's remand in *Tellabs* applied a variation of the core operations approach. In reversing the district court's grant of the motion to dismiss a complaint that the corporate defendant had made material misstatements about customer demand for several major products, the court held:

[I]t is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud. Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dra-

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37. *Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 987–88 (9th Cir. 2008); see also *Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 270 (3d Cir. 2009) (holding that chief financial officer's denials of widespread discounting involving many different product lines and accounts, including some of the company's largest clients, was of such a "substantial magnitude" that the alleged misrepresentations supported an inference of recklessness, whereas "[i]f the alleged discounting were minor or restricted to only a few products or customers, we would be reluctant to infer that [his] denials were culpable"); *Desai v. Gen. Growth Props., Inc.*, 654 F. Supp. 2d 836, 860 (N.D. Ill. 2009) (finding that scienter was adequately pleaded insofar as the claim related to the allegations that "the company's very survival was at stake, and so . . . the insider Defendants either had to know about General Growth's ability or inability to refinance its looming debt or, if they did not, such lack of knowledge would amount to reckless disregard"). In one case applying this concept, the court upheld a complaint in part, concluding that "[t]he individual defendants were not entitled to make statements concerning the company's financial statements and ignore reasonably available data that would have indicated that those statements were *materially* false or misleading." *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 491 (S.D.N.Y. 2004) (emphasis added). For a vigorous argument for the application of the core operations doctrine, see Kaufman & Wunderlich, *supra* note 27, *passim*.

Professor Olazábal maintains that her approach differs from the core operations doctrine. Olazábal, *supra* note 21, at 1431 n.75. It is beyond the scope of this article to evaluate the differences between the core operations doctrine and Professor Olazábal's thesis.

38. See, e.g., *Plumbers & Pipefitters Local Union No. 630 Pension-Annuity Trust Fund v. Arbitron Inc.*, 741 F. Supp. 2d 474, 490 (S.D.N.Y. 2010) (dismissing complaint in part, declining to apply "core operations" doctrine where the complaint rested on "more nuanced, small-bore details").

39. See, e.g., *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 1000–01 (9th Cir. 2009) (upholding dismissal of complaint and summarizing the narrow scope of the core operations inference); see also *Matrix Capital Mgmt. Fund, LP v. BearingPoint, Inc.*, 576 F.3d 172, 182–92 (4th Cir. 2009) (upholding dismissal of complaint for failure to plead scienter, notwithstanding the significance of the allegedly undisclosed information).

matic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.<sup>40</sup>

Applying a similar analysis to the claim against the company's chief executive officer,<sup>41</sup> the court observed that the *Sundstrand* recklessness test that "the danger was either known to the defendant or so obvious that the defendant must have been aware of it"

looks like two criteria—knowledge of the risk and how big the risk is—but as a practical matter it is only one because knowledge is inferable from gravity ("the danger was either known to the defendant or so obvious that the defendant must have been aware of it"). When the facts known to a person place him on notice of a risk, he cannot ignore the facts and plead ignorance of the risk.<sup>42</sup>

This explanation begs the question of the relevance of the defendant's awareness or appreciation of the "gravity" of the facts, as well as what the analysis is when the facts are not "grave" but may be found to be material, unless the court was saying that a defendant acts recklessly only when the omitted or misrepresented facts were "grave."

Especially after the Supreme Court's directive in *Tellabs* to consider the totality of the complaint in assessing whether scienter has been pleaded,<sup>43</sup> the application of the core operations doctrine is very case-specific and, as noted earlier, the doctrine does not provide a sure path to pleading scienter.<sup>44</sup> Thus, courts may hold that sheer magnitude of the alleged deception alone is not sufficient to allege scienter, which suggests that proving scienter at trial based largely on the materiality of information may not be successful. An assessment of how any materiality-based test for scienter applies requires a comprehensive understanding of the concept of materiality under Rule 10b-5.

## II. THE LAW OF MATERIALITY UNDER RULE 10b-5

Materiality is a separate element of any cause of action under Rule 10b-5, whether a private action for damages or a criminal or civil enforcement

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40. *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008).

41. *Id.* at 711 ("Is it conceivable that he was unaware of the problems of his company's two major products and merely repeating lies fed to him by other executives of the company? It is conceivable, yes, but it is exceedingly unlikely.")

42. *Id.* at 704.

43. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322–23, 325 (2007).

44. See *supra* text accompanying note 39; see also *In re Spear & Jackson Sec. Litig.*, 399 F. Supp. 2d 1350, 1359, 1362–63 (S.D. Fla. 2005) (dismissing complaint against accountant where magnitude of the deception was only one factor, among others, in determining whether scienter has been pleaded and upholding complaint against chief executive officer where his "inaction in the face of such suspicious accounting problems alone may not rise to 'severe' recklessness, [but] factoring in [his] clear motive and opportunity to mislead investors creates sufficient severity"). This is consistent with the approach advocated by Professor Olazábal, who would base the inference of scienter on three factors, not only on the magnitude of the misrepresentation or omission, in light of the defendant's position within the corporation. See *supra* text accompanying note 33.

action.<sup>45</sup> In an action under Rule 10b-5, a fact is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making his investment decision.<sup>46</sup> An omitted fact is material if there is “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.”<sup>47</sup> The test is not just *more probable than not* that the reasonable investor would consider the fact important, nor even substantially likely that the investor *might* consider it important.<sup>48</sup>

“The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.”<sup>49</sup> Materiality is a mixed question of fact and law.<sup>50</sup> Because of this, materiality

45. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008) (identifying materiality as a separate element of the private cause of action); *supra* note 3 (stating that materiality is an element of an enforcement action for a violation of Rule 10b-5).

46. *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (action under SEC Rule 14a-9, 17 C.F.R. § 240.14a-9)). For discussions of the concept of materiality, see Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 *Bus. Law.* 317 *passim* (2007); Horwich, *supra* note 4, at 1026–32. Both articles address, among other sources, SEC Staff Accounting Bulletin No. 99—Materiality, 64 *Fed. Reg.* 45150 (Aug. 19, 1999), available at <http://www.sec.gov/interp/account/sab99.htm>.

47. *Basic*, 485 U.S. at 231–32 (quoting *TSC*, 426 U.S. at 449).

48. These may seem to be fine, or even trivial, distinctions, but one very important aspect of *TSC*, 426 U.S. at 446–47, was its correction of a “misplaced” reliance on statements in two earlier decisions of the Court that were interpreted by some to establish the test for materiality to be those facts that “might” rather than “would” influence an investor. In *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970), the Court had stated that a determination of materiality “indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder,” and in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153–54 (1972), the Court had stated, “All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.” See *The Supreme Court, 1975 Term: Narrowing Liability Under the 1934 Act*, 90 *HARV. L. REV.* 255, 261 (1976) (“Justice Marshall [in *TSC*] dismissed as dicta statements in previous cases indicating that the Court had adopted the ‘might’ standard.” (footnote omitted)). Compare *Marx v. Computer Scis. Corp.*, 507 F.2d 485, 489 & n.6 (9th Cir. 1974) (applying test of whether a reasonable man would attach importance to the fact misrepresented in determining his choice of action in the transaction in question, noting the language in both *Affiliated Ute* and *Mills* but “adher[ing] in 10b-5 cases to the traditional and less speculative common law language of the objective test” (internal quotation marks and citations omitted)), with *SEC v. First Am. Bank & Trust Co.*, 481 F.2d 673, 681 (8th Cir. 1973) (“The standard [of materiality] in omission or non-disclosure cases should be whether a reasonable man in the position of an investor might well decide not to purchase the security if the fact or facts were disclosed,” citing *Affiliated Ute* and *Mills*).

49. *TSC*, 426 U.S. at 445. But see Steven M. Davidoff, *In Corporate Disclosure, a Murky Definition of Material*, *N.Y. TIMES*, Apr. 6, 2011, at B6 (stating, after quoting the “total mix” definition of materiality, that it “is a subjective legal standard”).

50. See *TSC*, 426 U.S. at 450 (“The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. . . . Only if the established omissions are ‘so obviously important 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’ by summary judgment.” (quoting *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970))).

is not often decided at the pleading stage of a case.<sup>51</sup> Materiality is often an actively disputed issue after the pleading stage.<sup>52</sup>

At the pleading stage, therefore, the differences between the parties more commonly focus on issues such as scienter or whether the statements made were in fact false.<sup>53</sup> Nevertheless, where materiality is disputable, even if not capable of resolution on the pleadings as a separate issue, the issue of scienter may be interwoven with the materiality of the alleged omission or half-truth. The analysis presented in this article applies to that class of cases, and if the thesis presented here is correct then defendants should give more careful consideration before they gloss over or effectively concede the issue of materiality.

Where the allegedly deceptive statement is about something that has not yet occurred, “materiality ‘will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.’”<sup>54</sup> In *Basic*, the Court held only that the probability/magnitude test applies to merger negotiations.<sup>55</sup> The test is now routinely applied to a wide array of disclosures that have a forward-looking element to them. The case from which *Basic* drew the probability/magnitude test involved an evolving situation regarding the discovery of minerals.<sup>56</sup> The test has since been applied in cases involving the riskiness of assets owned by a financial firm,<sup>57</sup> a

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51. Nevertheless, whether a fact is immaterial can be decided by a court on a motion to dismiss or for summary judgment. See, e.g., *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425–27 (3d Cir. 1997) (finding certain alleged omissions immaterial as a matter of law in affirming, in part, grant of motion to dismiss for failure to state a claim); *SEC v. Siebel Sys., Inc.*, 384 F. Supp. 2d 694, 704 (S.D.N.Y. 2005) (“where the subject statements are so blatantly unimportant, it is appropriate for the Court to rule, as a matter of law [on a motion to dismiss], that the statements do not meet the materiality threshold, and to dismiss the complaint”). This is in addition to statements that are immaterial because they are covered by the statutory safe harbor for forward-looking statements or the comparable bespeaks caution doctrine, or are mere puffery. See Allan Horwich, *Cleaning the Murky Safe Harbor for Forward-Looking Statements: An Inquiry into Whether Actual Knowledge of Falsity Precludes the Meaningful Cautionary Statement Defense*, 35 J. CORP. L. 519, 526–27 & n.38, 556–59 (2010).

Courts rarely find facts to be material as a matter of law where the issue is contested, however. Cf. *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987, 989, 991–95 (2d Cir. 1988) (reversing bench trial judgment for defendant, remanding for determination of damages and ordering entry of judgment for plaintiff, finding that certain facts were material, stating: “The facts are not in dispute. In such a case, we are in as good a position as the district court to draw inferences and conclusions from the facts.”); *SEC v. Bauer*, No. 03-C-1427, 2011 WL 2115924, at \*13–17 (E.D. Wis. May 25, 2011) (finding materiality as a matter of law on summary judgment motion).

52. See, e.g., *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 535–43 (S.D.N.Y. 2011) (noting that “defendants collectively put on a spirited defense” at trial though rejecting motion to set aside the verdict where the “jury was well within its prerogatives in . . . finding that material misstatements and omissions were made” by the corporate defendant).

53. See *supra* text accompanying notes 37–42.

54. *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).

55. *Basic*, 485 U.S. at 232 n.9 (“We do not address here any other kinds of contingent or speculative information, such as earnings forecasts or projections.”).

56. *Basic*, 485 U.S. at 238 (citing *Tex. Gulf Sulphur*, 401 F.2d at 849).

57. *In re Bear Stearns Cos., Inc. Sec., Derivative, and ERISA Litig.*, 763 F. Supp. 2d 423, 519–20 (S.D.N.Y. 2011) (holding that materiality was adequately pleaded).

potential corporate restructuring,<sup>58</sup> contingent financing,<sup>59</sup> plans to oust a member of the board of directors,<sup>60</sup> plans to construct a new manufacturing facility,<sup>61</sup> and entry into a new sales contract,<sup>62</sup> among many contexts.<sup>63</sup>

The recent Supreme Court decision in *Matrixx* suggests just how fact- (and judgment-) intensive materiality determinations can be. The Rule 10b-5 claim at issue there was brought by investors in a pharmaceutical company that had failed to disclose adverse event reports regarding a product whose sales were a significant component of the company's revenues.<sup>64</sup> As it had in *Basic*, where the issue was the materiality of merger negotiations, the Court rejected a bright-line test of materiality proposed by the defendants, who contended that the event reports were material under the securities laws only if they were "statistically significant."<sup>65</sup> Following the *Basic* "total mix" test,<sup>66</sup> the Court held that determining whether adverse event reports were material to investors "requires consideration of the source, content, and context of the reports. This is not to say that statistical significance (or the lack thereof) is irrelevant—only that it is not dispositive of every case."<sup>67</sup> The Court then held that the allegations of the complaint "'raise a reasonable expectation that discovery will reveal evidence' satisfying the materiality requirement."<sup>68</sup> The analysis leading to this conclusion required a review of all

58. *SEC v. Rorech*, 720 F. Supp. 2d 367, 411 (S.D.N.Y. 2010) (holding on the merits information was not material).

59. *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987, 993 (2d Cir. 1988) (reversing bench trial judgment in favor of defendants and ordering entry of judgment for plaintiff, holding that information was material).

60. *In re Gen. Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1128 (D. Del. 1988) (holding on motion to dismiss that certain information was not material).

61. *Milton v. Van Dorn Co.*, 961 F.2d 965, 969–72 (1st Cir. 1992) (affirming summary judgment for defendants, holding that information was not material).

62. *Gay v. Axline*, No. 93-1491, 1994 WL 159426, at \*6–8 (1st Cir. Apr. 26, 1994) (affirming bench trial judgment in favor of defendants that information was not material, albeit on different analysis than applied by the district court).

63. For other examples, see J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* § 5.05[3][c], at 5-77 (3d ed. 2011). While the PSLRA affected the requirements for pleading both the deceptive character of a statement and scienter, the PSLRA did not affect either the definition of what is material, as developed by the courts, or pleading materiality. See *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 *passim* (2011) (relying principally on the pre-PSLRA cases *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) and *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) to determine whether the complaint alleged deception).

64. *Matrixx*, 131 S. Ct. at 1313, 1323.

65. *Id.* at 1318–19.

66. See *supra* text accompanying note 47.

67. *Matrixx*, 131 S. Ct. at 1321. The Court elaborated that

the mere existence of reports of adverse events—which says nothing in and of itself about whether the drug is causing the adverse events—will not satisfy this standard. Something more is needed, but that something more is not limited to statistical significance and can come from "the source, content, and context of the reports," *supra* at 1321. This *contextual inquiry* may reveal in some cases that reasonable investors would have viewed reports of adverse events as material even though the reports did not provide statistically significant evidence of a causal link.

*Id.* (emphasis added) (footnote omitted). This aspect of *Matrixx* was not affected by any of the heightened pleading requirements imposed by the PSLRA because the PSLRA did not change the pleading standard for the element of materiality. See *supra* note 63.

68. *Matrixx*, 131 S. Ct. at 1323 (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 556 (2007)).

of the information alleged to have been available to the defendants, as matched against the (allegedly misleading) statements made by Matrixx.<sup>69</sup>

It is often said that materiality can be inferred from the defendant's own actions.<sup>70</sup> This approach, however, is not dispositive of the question of materiality.<sup>71</sup> One commentator has criticized this approach to determining materiality:

A major issue in insider trading cases is whether the allegedly insider trading behavior can serve as proof that the facts on which the insider traded were material. The problem, of course, is the potential for bootstrapping: if the allegedly illegal trade proves that the information is material, the materiality requirement becomes meaningless—all information in the defendant's possession when he or she traded would be material.<sup>72</sup>

For this reason, an irrebuttable presumption would improperly beg the question of cause and effect by avoiding the fundamental factual issue of whether learning the information was the reason for the trade or was just one of many factors—or no factor at all—resulting in a trade *at that time*.<sup>73</sup> (This of course applies only where the person actually knew the information, which may be contested.) That is, a person could trade for any number of reasons unrelated to a specific fact regarding the particular security.<sup>74</sup> Moreover, this *post hoc ergo propter hoc* approach may fail to take simple elements of timing into account. Suppose fact X emerges on Day 1, and the insider becomes aware of it at that time. The fact remains undisclosed to the public, and on Day 40 the insider

69. *Id.* at 1322–23.

70. See, e.g., SEC v. Maio, 51 F3d 623, 637 (7th Cir. 1995) (holding that trading while aware of information “tends to show” that the information was material); Rubinstein v. Collins, 20 F3d 160, 170 n.39 (5th Cir. 1994) (observing that trading prior to disclosure is “indicative” of materiality); SEC v. Rorech, 720 F. Supp. 2d 367, 412 (S.D.N.Y. 2010) (“courts often look to the actions of those who were privy to the information in determining materiality”); see also WILLIAM K. S. WANG & MARC I. STEINBERG, INSIDER TRADING § 4.2.2, at 112 n.54 (3d ed. 2010) (collecting cases).

71. See, e.g., Abromson v. Am. Pac. Corp., 114 F3d 898, 903 n.3 (9th Cir. 1997) (“the presence of insider sales is at most probative of materiality”); Chelsea Assocs. v. Rapanos, 527 F2d 1266, 1270 (6th Cir. 1975) (affirming ruling in favor of defendant that undisclosed fact was not material although defendant had sold stock knowing this information, stating, “[T]he importance a defendant insider attaches to information in deciding whether to purchase or sell stock is highly persuasive evidence of materiality. . . . However, we do not understand such evidence to be conclusive.”).

72. STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 36 (2d ed. 2007).

73. The SEC's position is that an insider who trades in his company's stock while “aware” of material nonpublic information violates Rule 10b-5 in the absence of a defense, such as that the trade was prearranged in compliance with Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2011). See Selective Disclosure and Insider Trading, Securities Act Release No. 7881, 65 Fed. Reg. 51716, 51727–29 (Aug. 24, 2000) (codified at C.F.R. pts. 240, 243 & 249). For a comprehensive discussion of that rule, and the SEC's position that Rule 10b5-1 affords the only affirmative defenses to a claim of insider trading, see Allan Horwich, *The Origin, Application, Validity and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913 (2007). The issue addressed in the present article, however, is not the availability of affirmative defenses but whether the defendant's own trading establishes the materiality of everything nonpublic of which he is, or might be, aware.

74. See, e.g., 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT, AND PREVENTION § 5:2, at 5-12 (2011) (“A professional analyst, for example, is constantly evaluating the companies for which he is responsible, using a wide variety of information sources. The mere fact that he causes his clients to buy or sell after receiving some nonpublic information does not prove conclusively that his recommendation was based on that information.”). The author then notes, however, that “in

trades. It is tenuous to infer that, *because* the insider traded on Day 40, X was a material fact at the time of the trade. The inference would be much stronger had the trade occurred on Day 1, immediately after the insider learned of the information, or even Day 10.

The need for caution in inferring materiality from the fact of trading has a parallel with inferring scienter from the act of trading. Although trading by insiders at a time when they are alleged to have known material nonpublic information may support an inference of scienter, either at the pleading stage or on the merits, the mere act of trading does not inevitably lead to the inference that there was an intent to deceive. Whether trading by insiders is indicative of scienter depends on the character of the trading, such as the number of shares involved in comparison to the defendant's holdings and whether the trading departed from prior patterns of the defendant's trading in the company's stock.<sup>75</sup>

From the foregoing discussion there should be no doubt that deciding whether a fact is material *ex ante* is often not easy. As the Supreme Court held in its first definitive opinion on materiality under the securities laws, "The determination [of materiality] 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 . . . ."<sup>76</sup> In addressing the complexity of the determination of materiality, one commentator stated:

The first tremors of a problem that eventually bankrupt a business, particularly if confined to a segment or subdivision of the company, might go unrecognized by

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many cases, the fact of trading is largely inexplicable except by saying that the insider or tippee felt that the information in question was indeed significant." *Id.*; see also Declaration of Marc I. Steinberg ¶ 3, United States v. Stewart, No. 03 CR 717 (S.D.N.Y. Feb. 19, 2004), reprinted in MARC I. STEINBERG, SECURITIES REGULATION 657–59 (5th ed. 2009) ("Corporate executive officers and directors, including CEOs, sell shares of a subject company's stock for a variety of reasons, many of which have nothing to do with the subject company. It is well known that a CEO of a U.S. publicly-held company may sell stock: because he/she needs money to use for personal or business purpose(s); to ameliorate margin dilemmas in his/her securities account(s); to diversify the CEO's portfolio to include a broader number and type of investments; to convey a gift; to generate cash to repay a loan or for some other obligation; or for tax planning purposes (especially at the end of the year). Normally, these reasons are irrelevant to the subject company and communicate no useful information to investors about the subject company.").

75. *Miss. Pub. Emps.' Ret. Sys. v. Bos. Scientific Corp.*, 523 F.3d 75, 92–93 (1st Cir. 2008) (holding that allegations of insider trading by the defendants supported the element of scienter, recognizing that "[i]nsider trading in suspicious amounts or at suspicious times may be probative of scienter"). On remand, the court granted summary judgment in favor of the defendants. On the element of scienter, the lower court ruled that the plaintiffs' claims of defendants' insider trading did not support proof of scienter where, among other factors, some defendants increased their holdings and many of the defendant sellers did not make sales "well beyond normal sales patterns." *In re Bos. Scientific Corp. Sec. Litig.*, 708 F. Supp. 2d 110, 127 (D. Mass. 2010), *aff'd sub nom. Miss. Pub. Emps.' Ret. Sys. v. Bos. Scientific Corp.*, 649 F.3d 5, 29 (1st Cir. 2011); see also *Metzler Inv. GmbH v. Corinthian Colls., Inc.*, 540 F.3d 1049, 1067 (9th Cir. 2008) (finding allegations of stock trading by defendants did not support conclusion of scienter, where, among other factors, only one defendant made large sales, many of which were before the occurrence of a government agency investigation that allegedly was not disclosed on a timely basis, another defendant sold "only" 37 percent of his holdings during the class period, and many sales were in a manner consistent with pre-class period sales). For an extensive discussion of pleading scienter by alleging the defendant's insider trading, see PERINO, *supra* note 17, § 3.01D.5.b, at 3-133 to -145.

76. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976).

the most astute observer, yet become a clear harbinger of disaster when considered in light of later developments. Similarly, it may be difficult to assess the materiality of information that was incomplete at the relevant date. In insider trading cases, for example, a company insider may argue that the non-public information to which the insider was privy at the time of the trading was too vague, partial, or preliminary to have driven his or her investment decisions. In such situations, hindsight may prove a particularly unreliable guide.<sup>77</sup>

Another commentator observed, “Figuring out what exactly constitutes material information is largely an exercise in futility because the Supreme Court has adopted a definition so vague that almost any tidbit about a company could fall within it.”<sup>78</sup> As a result, jury determinations of materiality “seem to boil down largely to Justice Potter Stewart’s oft-cited shibboleth about pornography, ‘I know it when I see it.’”<sup>79</sup> One longtime critic of the law of insider trading under Rule 10b-5<sup>80</sup> recently expressed his judgment that “no one even knows with anything like the certainty required in other areas of criminal law what is even meant by such legally critical words as ‘material nonpublic information’ . . . .”<sup>81</sup> Newly minted law students are explicitly warned of the complexities of this area.<sup>82</sup>

77. Sauer, *supra* note 46, at 323 (footnotes omitted); see also Hodges, *supra* note 4, at 36–37 (advocating a broad interpretation of materiality while also discussing how implementation of Staff Accounting Bulletin No. 99—Materiality, *supra* note 46, “is undeniably fraught with ambiguity, uncertainty, and unpredictability”).

78. Peter J. Henning, *A Standard that Raises More Questions than Answers*, N.Y. TIMES, Apr. 7, 2011, at F6.

79. *Id.* The author further observed, “The S.E.C. relies on the vague materiality standard apparently because it provides greater flexibility in deciding whether to pursue an enforcement action for a failure to disclose. Absent a clearer definition, companies are kept guessing about what comprises material information, perhaps so they will disclose more information to be safe.” *Id.* This outcome would be contrary to the expressed reasoning in *TSC*, however, where the Court stated that if there were too low a threshold for materiality, management would “bury the shareholders in an avalanche of trivial information.” *TSC*, 426 U.S. at 448–49.

80. See HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). Professor Manne has described the “three basic economic arguments” he made there in the following language: “One was that the practice of insider trading did no significant harm to long-term investors. The other two were claims of positive benefits from the practice: one, the compensation argument, and the other, the idea that insider trading contributed importantly to the efficiency of stock market pricing.” Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 168 (2005). He has also attacked what he refers to as “[t]he SEC’s notoriously ineffective, but highly publicized and politicized, efforts to enforce insider trading laws.” *Id.* at 173. One might, therefore, take his criticism of the subsidiary issue of materiality with a grain of salt.

81. Henry G. Manne, *Enforcing Insider Trading Laws—Confusion Compounded*, NETNET WITH JOHN CARNEY (May 9, 2011, 9:55 AM EST), <http://www.cnbc.com/id/42956290>. Most recently, practitioners participating in a webcast on materiality observed that “materiality is truly an elusive concept,” that “the standard [of materiality] is clear, but its application is very difficult,” and “materiality is one of the most difficult determinations. And it’s going to remain[] that way. I think the Supreme Court decision [in *Matrixx*] is saying, ‘Go out there and struggle, and best of luck for the next few years.’” Materiality: The Hardest Determination 1, 5, 10 (Oct. 5, 2011) (transcript available at [http://www.thecorporatecounsel.net/member/Webcast/2011/10\\_05/transcript.htm](http://www.thecorporatecounsel.net/member/Webcast/2011/10_05/transcript.htm)).

82. One leading casebook states, “Outside of litigation, considering whether an item is material and thus must be disclosed is frequently an ulcerating experience.” JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION CASES AND MATERIALS* 586 (6th ed. 2009). Two other casebook authors state, “Unfortunately, determining whether a particular morsel of information is material is often an uncertain process.” STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES*

As noted earlier, the thesis of this article likely applies most often, but not exclusively, to situations where facts have been omitted, including half-truths.<sup>83</sup> This may arise when the omission relates to something that has not yet occurred, such as trading in securities of a company that is alleged to be the subject of an undisclosed pending acquisition. The materiality of any failure to disclose that circumstance implicates the application of the probability/magnitude test,<sup>84</sup> which is even more knotty than determining the materiality of so-called hard, i.e., historical, facts. This test is a “highly fact-dependent” one,<sup>85</sup> laden with uncertainty. For example, focusing on applying the test in the context of insider trading, one leading commentator has observed:

Although the probability/magnitude language sounds technically sophisticated and precise, in fact it is inherently subjective and indeterminate. . . . [T]here is no magic product to serve as a threshold above which information becomes material. The court never tells us how high a probability nor how large a magnitude is necessary for information to be deemed material. One thus inside trades on the basis of speculative information knowing that a jury, acting with the benefit of hindsight, may reach a different conclusion about how probability and magnitude should be balanced than you did.<sup>86</sup>

In practice this test is very difficult to apply before the fact,<sup>87</sup> with a significant risk of hindsight bias when a case is litigated.<sup>88</sup>

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AND ANALYSIS 50 (3d ed. 2012). Authors of a leading student securities law text caution, “For the securities lawyer worrying about disclosure, digging to find nonspecified information and then determining whether it is material takes the most skill and judgment.” LARRY D. SODERQUIST & THERESA A. GABALDON, *SECURITIES LAW* 72 (4th ed. 2011).

83. See *supra* text accompanying note 5 and *infra* note 135.

84. See *supra* text accompanying note 54.

85. *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.16 (1988).

86. BAINBRIDGE, *supra* note 72, at 35–36; see also SODERQUIST & GABALDON, *supra* note 82, at 136 (“Understanding the substantial-likelihood standard itself is relatively easy. It is sometimes difficult, however, to predict what misstatement or omission a court will determine fits under the standard.”).

87. See, e.g., BROWN, *supra* note 63, § 5.05[3][a], at 5-71 to -72 (describing “magnitude” and “probability” as “elusive terms,” noting that magnitude “may depend in part upon one’s vantage point,” and stating that “[p]robability essentially requires a look into a crystal ball”); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1337 (1999) (“[I]n my experience, the largest portion of the frustration that insiders have in deciding whether they can trade in a particular situation comes in trying to characterize the significance of the information that they know under the so-called ‘probability/magnitude’ test.” (footnote omitted)).

88. Hindsight bias in securities litigation was summarized in one leading article:

Hindsight blurs the distinction between fraud and mistake. People consistently overstate what could have been predicted after events have unfolded—a phenomenon psychologists call the hindsight bias. People believe they could have predicted events better than was actually the case and believe that others should have been able to predict them. Consequently, they blame others for failing to have foreseen events that reasonable people in foresight could not have foreseen. In the context of securities regulation, hindsight can mistakenly lead people to conclude that a bad outcome was not only predictable, but was actually predicted by managers. Even in the absence of any misconduct, a bad outcome alone might lead people to believe that corporate managers committed securities fraud. The hindsight bias thus creates a considerable obstacle to the fundamental task in securities regulation of sorting fraud from mistake.

Gulati, Rachlinski & Langevoort, *supra* note 4, at 774 (footnotes omitted). This bias particularly affects materiality determinations in securities litigation. *Id.* at 790 (“After the material event occurs, the warning sign will come to seem like a clear harbinger of the adversity that followed. Numerous studies

### III. AUTHORITIES THAT ADDRESS THE INTERSECTION OF SCIENTER AND MATERIALITY

The law of Rule 10b-5 thus provides, in both the private liability and enforcement contexts, that the defendant violates the rule only if he acts with an intent to deceive.<sup>89</sup> In many cases, the materiality of the information that was misrepresented or that was not disclosed is clear.<sup>90</sup> In other situations, however, the defendant may have thought about what he was about to say (such as utter a statement about a public company of which he is a senior executive) or do (such as trade in stock of that company) and reached a good-faith conclusion that nonpublic information of which he was aware was not material—or he was not reckless in failing to appreciate the materiality of the substantive deficiency of his statement. The remainder of this article focuses on those situations.

#### A. THE COMMON LAW BACKGROUND FOR AN ANALYSIS OF SCIENTER UNDER RULE 10b-5

If the facts are not material their omission would not be expected to influence the behavior of the (reasonable) investor. It would indeed be an odd use of language to say that someone intended to deceive another—to influence her action—by failing, even intentionally, to disclose to her facts that the (reasonable) investor *would not consider important*. In ordinary discourse one would not say, “I intended to deceive her by failing to disclose something I did not expect would factor into her decision.” In that situation there is no *intent* to deceive.<sup>91</sup>

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of the hindsight bias reveal that knowing the outcome makes the antecedents seem more significant than was actually the case.” (footnote omitted).

89. This article focuses on material deception through false statements or through silence when there is a duty to speak, including alleged trading while aware of material nonpublic information. Rule 10b-5 is broader than that. In addition to deceptive statements and manipulation (with “manipulation” narrowly construed, *see Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476–77 (1977)), Rule 10b-5 also reaches deceptive non-verbal conduct. *See Stoneridge Inv. Partners, LLC v. ScientificAtlanta, Inc.*, 552 U.S. 148, 158 (2008) (“[a conclusion suggesting that] there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5 . . . would be erroneous. Conduct itself can be deceptive . . .”); 7 LOSS & SELIGMAN, *supra* note 19, at 3536–41 (3d ed. 2004) (discussing non-verbal acts, such as a broker’s unauthorized trading in a customer account).

90. *See, e.g., supra* text accompanying notes 37–42 (discussing the core operations doctrine).

91. Consider the following:

For a *large* class of cases—though not for all—in which we employ the word “meaning” it can be defined thus: the meaning of a word is its use in the language.

. . . .

One cannot guess how a word functions. One has to *look at* its use and learn from that.

LUDWIG WITTGENSTEIN, *PHILOSOPHICAL INVESTIGATIONS* § 43, at 20, § 340, at 109 (G.E.M. Anscombe trans., 3d ed. 1958). If a term has an established meaning in the legal context, of course that should be used. The “ordinary” meaning and the “legal” meaning may be close, if not identical, as they are in the case of “intend.”

Intend = (1) in ordinary language, to desire that a consequence will follow from one’s conduct; or (2) in legal language, to contemplate that consequences of one’s act will necessarily or probably follow from the act, whether or not those consequences are desired for their own sake.

BRYAN A. GARNER, *A DICTIONARY OF MODERN LEGAL USAGE* 457 (2d ed. 1995).

This is in accord with many common law precedents.<sup>92</sup> The common law of deceit is an appropriate starting point to analyze the meaning of “intent to deceive” because that was the source of the ruling in *Hochfelder* interpreting the operative words of section 10(b) of the Exchange Act.<sup>93</sup> One widely accepted interpretation of the common law of fraud and deceit is that

One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from acting in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.<sup>94</sup>

The *Restatement* was relied upon in the following judicial summary of the common law of intent to deceive:

The intent element of common-law civil fraud is well established. According to the Restatement . . . , “One who fraudulently makes a misrepresentation . . . for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit. . . .” RESTATEMENT (SECOND) OF TORTS § 525 (1976); see also W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS, § 105, at 728 (5th ed. 1984) (“an intention to induce the plaintiff to act or refrain from action in reliance upon the misrepresentation” is an element of [the] tort of deceit). Commentary roughly contemporary with the Congress that enacted the mail fraud statute in 1872 gives a similar definition of the intent element. “It is said that a man is liable to an action for deceit if he makes a false representation to another, knowing it to be false, but intending that the other should believe and act upon it. . . .” OLIVER WENDELL HOLMES, JR., THE COMMON LAW 132 (1881); see also 2 CHARLES G. ADDISON, A TREATISE ON THE LAW OF TORTS § 1174, at 398 (H.G. Wood ed., 1881) (“If a falsehood be knowingly told, with

92. The myriad cases that apply the concept of “intent to deceive” as an element of common law deceit are not consistent, however. For a survey of the law of scienter at common law, see FOWLER V. HARPER, FLEMING JAMES, JR. & OSCAR S. GRAY, HARPER, JAMES AND GRAY ON TORTS §§ 7.1–7.3 (3d ed. 2006).

93. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201–06 (1976), the Court looked to the commonly understood meaning of the words in the statute (“manipulative,” “deceptive,” and “contrivance”) at the time the Exchange Act was adopted. It is likewise appropriate to consider what was meant by “intent to deceive” at that time. It is useful to recall the holding of *Hochfelder*—an action under Rule 10b-5 requires proof of scienter and “the term ‘scienter’ refers to a mental state embracing intent to deceive, manipulate, or defraud.” *Id.* at 193 & n.12.

94. RESTATEMENT (SECOND) OF TORTS § 525 (1977). This is substantially the same as the original version of the *Restatement*, with the changes in the final words, which had read “in reliance thereon in a business transaction is liable to the other for the harm caused to him by his justifiable reliance upon the representation.” RESTATEMENT OF TORTS § 525 (1938); see also *id.* Scope Note (“This Title [‘Fraudulent Misrepresentations’] deals only with the rules which determine the liability for pecuniary harm caused by fraudulent misrepresentations made for the purpose of influencing another’s conduct in a business transaction.” (emphasis added)).

Subsequent provisions in the *Restatement* define the “Conditions under which Misrepresentation is Fraudulent (Scienter)” and state the “General Rule” specifying the persons to whom the misrepresenter is liable for his misrepresentation, but they do not alter the basic “purpose” concept expressed in section 525. RESTATEMENT (SECOND) OF TORTS §§ 526, 531. Although section 531 extends liability to persons the misrepresenter “intends or has reason to expect to act or to refrain from action in reliance upon the misrepresentation,” nothing in that section suggests that the underlying wrong set forth in section 525 does not in all cases require a “purpose of inducing.” See *id.* § 531 cmt. a (“This Section deals with the persons to whom the maker of a fraudulent representation may be liable. The general rule of liability for fraudulent misrepresentation is stated in § 525.”).

an intention that another person should believe it to be true, and act upon it, . . . the party telling the falsehood is responsible in damages in an action for deceit . . .”).<sup>95</sup>

These common law antecedents strongly suggest that there was an intent to deceive only when one acted for the “purpose” of inducing another to (reasonably) rely. There should be no expectation, and thus purpose, that another would rely unless the information conveyed, or omitted, was of a sort that would influence the other, which is to say that the information was material.<sup>96</sup>

## B. RULE 10b-5 CASES RECOGNIZING THE RELEVANCE OF MATERIALITY TO SCIENTER

If, such as when the core operations doctrine is applied,<sup>97</sup> the magnitude of the allegedly undisclosed problems may support an inference of scienter in a claim against senior management, then the converse applies. Thus, where income had been overstated by less than 1 percent for the period in question, “any weight given to an inference of scienter because of the duration of the accounting irregularities must be tempered by their relatively small magnitude.”<sup>98</sup> To put

95. *United States v. Kenrick*, 221 F.3d 19, 28 (1st Cir. 2000) (holding that intent to deceive, but not intent to harm, is an element of the crime of federal bank fraud). *Kenrick* drew on the common law precedents in order to discern the meaning of the federal bank fraud statute, 18 U.S.C. § 1344, when it was enacted.

Language similar to that quoted from *Kenrick* appears in an earlier Supreme Court case under the federal securities laws:

Even in a damage suit between parties to an arm’s-length transaction, the intent which must be established need not be an intent to cause injury to the client, as the courts below seem to have assumed. “It is to be noted that it is not necessary that the person making the misrepresentations intend to cause loss to the other or gain a profit for himself; it is *only necessary that he intend action in reliance on the truth of his misrepresentations.*” 1 HARPER AND JAMES, *THE LAW OF TORTS* (1956), 531. “The fact that the defendant was disinterested, that he had the best of motives, and that he thought he was doing the plaintiff a kindness, will not absolve him from liability *so long as he did in fact intend to mislead.*” PROSSER, *LAW OF TORTS* (1955), 538. See 3 RESTATEMENT, *TORTS* (1938), § 531, Comment b, illustration 3. It is clear that respondents’ failure to disclose the practice here in issue was purposeful, and that they intended that action be taken in reliance on the claimed disinterestedness of the service and its exclusive concern for the clients’ interests.

*SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 n.39 (1963) (dictum) (emphasis added) (involving claim under the Investment Advisers Act of 1940).

96. In the context of bank fraud, “material” has a broader meaning than the “reasonable investor” test under the securities laws. See *supra* text accompanying notes 46–49. Bank fraud encompasses the situation where “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.” *Neder v. United States*, 527 U.S. 1, 22 n.5 (1999) (quoting RESTATEMENT (SECOND) OF TORTS § 538(b) (1977)).

If the statement or omission is not material, then of course there would be no liability in any event. The point here is that when materiality is disputable, intent may depend on the defendant’s state of mind with respect to the materiality of what he did not disclose.

97. See *supra* text accompanying notes 37–42.

98. *In re Dell Inc., Sec. Litig.*, 591 F. Supp. 2d 877, 894–95 (W.D. Tex. 2008). This case does not suggest that the absolute magnitude of the amount rendered it immaterial—a conclusion that would be at odds with both *Matrixx* (*supra* text accompanying notes 64–69) and the view of the SEC expressed in Staff Accounting Bulletin No. 99 (*supra* note 46)—but rather that the borderline nature of the materiality of the information is pertinent to the element of scienter. The court in *Dell* did not dismiss the complaint for the failure to allege *material* deception.

the issue in the typical terminology of recklessness, the “danger of misleading” was not “obvious.”<sup>99</sup> A claim was held not to allege scienter where “the [alleged] accounting irregularities . . . are significantly less egregious in nature and magnitude [than those in a case cited by the plaintiffs] and thus do not support a strong inference that nondisclosure of the correct numbers was the product of a deliberate or reckless effort by the Individual Defendants to defraud investors.”<sup>100</sup>

My earlier article on this topic cited cases that had suggested that the state of mind with regard to any assessment of the materiality of a statement was, or could be, a factor in the necessary scienter analysis.<sup>101</sup> In the nearly dozen years since that analysis, cases have addressed the relevance of the defendant’s consciousness

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99. See *supra* text accompanying notes 19–30.

100. *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 685–86 (6th Cir. 2004).

101. Horwich, *supra* note 4, at 1035–37. So that this article is self-contained, the cases discussed there are summarized in this footnote.

In a leading Supreme Court case on insider trading, three Supreme Court justices would have held that the defendant’s own perception of the materiality of information is directly pertinent to the determination of scienter. “[I]f the insider in good faith does not believe that the information is material or nonpublic, he also lacks the necessary scienter. . . . In fact, the scienter requirement functions in part to protect good faith errors of this type.” *Dirks v. SEC*, 463 U.S. 646, 674 n.11 (1983) (Blackmun, Brennan & Marshall, JJ., dissenting) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, 211 n.31 (1976)). The majority in *Dirks* arguably also looked to judgments about the materiality of disclosed information in assessing whether disclosure violated Rule 10b-5:

In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear—either to the corporate insider or to the recipient analyst—whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure.

*Id.* at 662 (majority opinion).

In *SEC v. MacDonald*, an enforcement action alleging unlawful insider trading, the court stated that the element of scienter “is satisfied if at the time defendant purchased stock he had actual knowledge of undisclosed material information, knew it was undisclosed, and knew it was material . . . .” 699 F.2d 47, 50 (1st Cir. 1983) (en banc) (emphasis added). The court found that this third element was satisfied “when [the trial court] specifically found that defendant’s inside information was a motivating factor in his purchase” of stock. *Id.* at 51.

In an earlier insider trading case, the U.S. Court of Appeals for the Second Circuit held that a tipper’s scienter is established where the tipper “deliberately tips information which he *knows to be material* and non-public to an outsider who may reasonably be expected to use it to his advantage.” *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 167 (2d Cir. 1980) (emphasis added) (footnotes omitted). The court recognized that there was contrary authority on whether knowledge of the nonpublic nature of the information was an element of scienter, but did not note any similar difference of opinion with regard to knowledge of materiality. *Id.* at 167 n.21. The court also reserved the question whether recklessness as to the materiality of the information would suffice to sustain a finding of scienter because there was actual knowledge of the materiality of the tip. *Id.* at 167 n.22.

In a case where the defendants had knowledge of undisclosed information but the materiality of those facts was uncertain, the court held that the defendants “did not know nor should have known the danger of misleading the customers by the omission.” *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 889 (5th Cir. 1987). In another case, after noting that a violation of section 10(b) can be proven without a showing of a specific intent to violate the law, the court held that scienter is established where the defendants “know the materiality of the concealed information and intend the consequences of concealment.” *Pittsburgh Terminal Corp. v. Balt. & Ohio R.R. Co.*, 680 F.2d 933, 943 (3d Cir. 1982). There would be no scienter, however, if the defendants relied on counsel

of, or inattention to (when not willfully ignorant), the materiality of the challenged statement in the context of the determination of scienter.

To be sure, there are many cases analyzing the scienter requirement that focus on the defendant's awareness of, or recklessness in not appreciating, the *falsity* of the statement he made, with no specific reference to whether or not the defendant appreciated the *materiality* of the falsity.<sup>102</sup> These decisions are not necessarily inconsistent with those cases, discussed next in the text, that do reflect consideration of the defendant's perception *vel non* of the materiality of an omitted fact or incomplete statement. No case has been found expressly rejecting consideration of the defendant's perception or analysis of the materiality of the facts known to him when determining whether the defendant is alleged to have acted with scienter.

In its first decision interpreting the heightened scienter pleading standard under the PSLRA,<sup>103</sup> the U.S. Court of Appeals for the Tenth Circuit took materiality into account in assessing the sufficiency of allegations of scienter.<sup>104</sup> The court held that

to establish scienter in a securities fraud case alleging non-disclosure of potentially material facts, the plaintiff must demonstrate: (1) the defendant knew of the potentially material fact, and (2) the defendant knew that failure to reveal the potentially material fact would likely mislead investors. The requirement of knowledge in this context may be satisfied under a recklessness standard by the defendant's knowledge of a fact that was so obviously material that the defendant must have been aware both of its materiality and that its non-disclosure would likely mislead investors.<sup>105</sup>

With respect to the particular claims regarding non-disclosure of litigation, the court held:

In regard to [the chief financial officer and principal accounting officer], Plaintiffs have provided no particular facts from which this court could plausibly infer their knowledge of the [undisclosed litigation], the underlying business practices at issue in that case, or the potential materiality of the lawsuit. . . . [T]he mere fact that the individual Defendants occupied senior positions in the company, and that two of them knew of the litigation at least by early 1995, is not sufficient to imply *knowledge of the specific fact of materiality*.<sup>106</sup>

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who "mistakenly but in good faith represent that some information is either immaterial or clear" because "[i]n such instances the defendants may not have an appreciation of the consequences of their conduct." *Id.* at 943. (For a further discussion of the relevance of reliance on counsel in this context, see *infra* text accompanying notes 136–46.) One court has read *Pittsburgh Terminal* as requiring that "in the context of an omissions case, plaintiffs must show that defendants knew or were reckless in disregarding the materiality of the consequences of the concealed fact." *Eacho v. N D Res., Inc.*, Civ. A. No. 83-2903, 1985 WL 1717, at \*3 (D.D.C. May 24, 1985). In so ruling, the court recognized that the plaintiff need not prove that the defendant thought his actions were illegal. *Id.*

102. See, e.g., *Gebhart v. SEC*, 595 F.3d 1034, 1042 (9th Cir. 2010) ("[A]lthough we may consider the objective unreasonableness of the defendant's conduct to raise an inference of scienter, the ultimate question is whether the defendant knew his or her statements were false, or was consciously reckless as to their truth or falsity.").

103. See *supra* note 17.

104. *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1248 (10th Cir. 2001).

105. *Id.* at 1261.

106. *Id.* at 1263–64 (emphasis added).

Dismissal of the complaint was affirmed for this and other reasons.<sup>107</sup> The court thus focused on whether the defendants appreciated or were presumed to have appreciated the materiality of the undisclosed facts.

A lower court decision, citing both *Sundstrand* and *Fleming Companies*, observed, in upholding dismissal of a complaint for failure to allege scienter, “[K]nowledge or reckless disregard of the potential materiality of the information misstated or omitted is an element of scienter [that is] based on allegations of intentional or reckless misconduct.”<sup>108</sup> While the facts alleged to have been omitted ultimately proved to be material, there were no allegations “constituting strong circumstantial evidence that [prior to disclosure] Defendants either knew or recklessly disregarded: . . . (2) that such information would reveal materially more [expenses] than had been estimated and publicly reported by [the company] in its financial statements.”<sup>109</sup> Moreover, even if company executives were alleged to have been aware of problems, the plaintiffs failed to allege “specific facts showing that Defendants either knew or should have known that any [amounts in question], once captured, would reveal a *material* difference” in expenditures compared to what had been estimated.<sup>110</sup>

One district court analyzed the scienter allegations with respect to non-defendant corporate officers in order to determine whether scienter had been alleged against the corporation, the sole defendant, where the essence of the allegations was that the company failed to disclose the questionable legality of its method of doing business, so that the statements it did make were materially incomplete. In dismissing the complaint for failure to plead scienter, the court observed:

[E]ven assuming that plaintiffs have adequately pleaded that such a person had actual knowledge of a particular fact and did not disclose it, this of itself is insufficient to raise a strong inference of scienter. Persons who sign, approve, or furnish information for SEC filings are often privy to myriad information that need not be released to the investing public. In fact, if marginally relevant information were disclosed in large volumes, it might prove counter productive [sic] by drowning out the disclosures that should catch the attention of investors and the investment community. Such persons do not therefore necessarily act with severe recklessness by failing to disclose all information of which they are aware [(citation omitted)]. Under the severe recklessness standard for inferring intent to defraud, the omission of information is not actionable unless the individual also has actual knowledge of a danger of misleading investors, or the danger is so obvious that the individual must have been aware of it [(citation omitted)].

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107. *Id.* at 1269–71.

108. *Wilson v. Bernstock*, 195 F. Supp. 2d 619, 639 (D.N.J. 2002) (quoting the statement in *Fleming Cos.*, 264 F.3d at 1260, that “allegations that the defendant possessed knowledge of facts that are later determined by a court to have been material, without more, is not sufficient to [permit an inference] that the defendant intentionally withheld those facts . . . or recklessly disregarded the importance of those facts”).

109. *Id.* at 639–40.

110. *Id.* at 642.

The complaint does not explain how any such individual acted with severe recklessness. Plaintiffs' allegations rest solely on an individual's knowledge of the facts that are set out in [the complaint]. The complaint does not explain why it would have been an extreme departure from the standards of ordinary care for any individual who signed, ordered, furnished information for, or otherwise had some responsibility for the SEC filings to conclude that the . . . allegations needed to be disclosed to prevent investors from being deceived.<sup>111</sup>

The import of this language is that the individuals did not act with scienter unless they recognized or were reckless in not recognizing the materiality of the information known to them that was not disclosed.

The cases discussed to this point predate the Supreme Court's decision in *Tellabs* in 2007, which construed the heightened pleading standard for scienter.<sup>112</sup> *Tellabs* did not, however, change the consideration of materiality when assessing scienter.<sup>113</sup> In *Matrixx*, the Court's most recent case addressing materiality and scienter, after finding that the complaint adequately pleaded the materiality of the alleged misrepresentations, the Court turned to the sufficiency of the scienter allegations. Accepting *arguendo* that recklessness suffices to plead scienter,<sup>114</sup> the Court did not find sufficiently plausible the defendants' proffered inference from the facts alleged that the defendants did not disclose the adverse event reports regarding the drug they sold because they "believed they were far too few . . . to indicate anything meaningful about adverse reactions" to the drug.<sup>115</sup> The Court concluded that

"taken collectively," [the allegations] give rise to a "cogent and compelling" inference that *Matrixx* elected not to disclose the reports of adverse events not because it believed they were meaningless but *because it understood their likely effect on the market*. "[A] reasonable person" would deem the inference that *Matrixx* acted with deliberate recklessness (or even intent) "at least as compelling as any opposing inference one could draw from the facts alleged."<sup>116</sup>

In other words, the allegations supported a plausible inference, at least as compelling as an exculpatory one, that the defendants decided not to disclose the adverse event reports *because they appreciated the materiality of the information*. While the use of the word "elected" in the preceding quotation sounds more like a deliberate decision than the recklessness the Court stated it was addressing,<sup>117</sup> the core

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111. *Milano v. Perot Sys. Corp.*, C.A. Nos. 3:02-CV-1269-D, 3:02-CV-1300-D, 3:02-CV-1533-D, 3:03-CV-0031-D, 3:03-CV-0032-D, 3:03-CV-0033-D, 3:03-CV-0356-D, 3:03-CV-0357-D, 2006 WL 929325, at \*14 (N.D. Tex. Mar. 31, 2006).

112. See *supra* note 17.

113. As also noted earlier, neither the adoption of the heightened pleading standard in the PSLRA nor the decision in *Tellabs* changed the substantive law of scienter. See *supra* note 17.

114. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1323–24 (2011).

115. *Id.* at 1324 (quoting from Brief for Petitioners).

116. *Id.* at 1324–25 (emphasis added) (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323, 324 (2007)).

117. In assessing the inferences that could be drawn from the allegations in the complaint, the Court stated, "The inference that *Matrixx* acted recklessly (or intentionally, for that matter) is at least as compelling, if not more compelling, than the inference that it simply thought the reports did not indicate anything meaningful about the adverse reactions." *Id.* at 1324.

of the analysis focused on the defendants' appreciation of the significance of the information: the defendants argued that it was plausible that they did not think the information was "meaningful," a synonym in this context for "material," and the Court found the contrary inference to be at least as strong. Thus, the defendants' perception of the significance of the information was at the very heart of the Court's scienter analysis. The defendants could argue to the jury that, before Matrixx announced that it could not determine if the active ingredient in the product had adverse effects,<sup>118</sup> the defendants in fact made a good-faith considered decision not to disclose the adverse event reports because they believed they were not material, or that disclosure of those reports could have portrayed an unduly negative picture as of the time the statements were made. As the Court stated, "Whether respondents can ultimately prove their allegations and establish scienter is an altogether different question."<sup>119</sup>

Turning to the lower courts after *Tellabs*, in the U.S. Court of Appeals for the Second Circuit whether scienter has been pleaded may include consideration of the defendant's consciousness of the materiality of the alleged deception in the context of whether there is strong circumstantial evidence of conscious misbehavior or recklessness.<sup>120</sup> In affirming the dismissal of a complaint, that court held that the plaintiffs had failed to plead the materiality of omitted facts. Given this failure, "Plaintiffs certainly did not plead that defendants had knowledge of the transactions' materiality," nor did they plead recklessness in the sense of ignoring a danger that was either known to them or so obvious that the defendants must have been aware of it.<sup>121</sup>

In the Ninth Circuit "[e]vidence showing that the defendants did not appreciate the gravity of the risk of misleading others is relevant" to a determination of whether they acted with deliberate recklessness or conscious recklessness as a species of scienter.<sup>122</sup> Most of the opinion just quoted from, however, appears to focus on the defendants' awareness of the falsity rather than on the perception of the materiality of the statements.

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118. *Id.* at 1316. Two commentators minimize the Court's apparent open-mindedness on this issue for trial. Kaufman & Wunderlich, *supra* note 27, at 47 ("[I]mplicit in the Court's conclusion is that the defendant's defense wouldn't fly because, in the Court's view, the defendants should have known the facts would have been material. In other words, whether the defendant was correct about the materiality of a fact is largely irrelevant—executives should know of facts that are material to investors.").

119. *Matrixx*, 131 S. Ct. at 1325.

120. *Kalnit v. Eichler*, 264 F3d 131, 142 (2d Cir. 2001) (applying test of strong circumstantial evidence of conscious misbehavior or recklessness pre-*Tellabs*); *ECA & Local 134 IBEW Joint Pension Trust v. JP Morgan Chase Co.*, 553 F3d 187, 202–03 (2d Cir. 2009) (same post-*Tellabs*).

In the pre-*Tellabs* case, *Kalnit*, the facts allegedly omitted were marginally material at most. Thus, "the duty to disclose [the omitted fact] was not so clear" and accordingly "defendants' recklessness cannot be inferred from the failure to disclose." 264 F3d at 143 (citing district court opinion in which the facts were held not to be material, an issue the court of appeals did not address directly, *id.* at 144). In *Kalnit* the plaintiff had been a stockholder in a company that had entered into an agreement to be acquired. The gravamen of his complaint was that prior to his sale of company stock the company had failed to disclose circumstances that might lead to a higher bid for the company. *Id.* at 134–37.

121. *ECA*, 553 F3d at 202–03.

122. *SEC v. Platforms Wireless Int'l Corp.*, 617 F3d 1072, 1093–94 (9th Cir. 2010) (affirming summary judgment for plaintiff).

In a decision by the U.S. Court of Appeals for the First Circuit,<sup>123</sup> the defendants were sued under Rule 10b-5 for failing to disclose that a regulatory change in Japan, where the company did significant business, would adversely affect the company's financial performance. In affirming dismissal of the complaint by the district court, the court of appeals stated:

The question of whether a plaintiff has pled facts supporting a strong inference of scienter *has an obvious connection to the question of the extent to which the omitted information is material*. . . . “[T]he question of whether Defendants recklessly failed to disclose [a fact] is . . . intimately bound up with whether Defendants either actually knew or recklessly ignored that the [fact] was material and nevertheless failed to disclose it.” *City of Philadelphia v. Fleming Cos.*, 264 F3d 1245, 1265 (10th Cir. 2001). If it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact.<sup>124</sup>

Further, “the key question” is not whether the defendants had knowledge of certain undisclosed facts, but rather whether the defendants knew or should have known that their failure to disclose those facts presented a danger of misleading buyers or sellers.<sup>125</sup> Taking into account the magnitude and probability that the change in Japanese government regulations would affect the company's business, “viewed objectively, the inferences are stronger that defendants did not knowingly or recklessly risk misleading the reasonable investor, as defendants reasonably did not expect that the change in Japanese drinking water testing regulations would itself have a significant impact on Waters' overall worldwide sales during 2007, such as to require disclosure.”<sup>126</sup> This decision clearly applied an analysis of what the defendants themselves (reasonably) expected in the court's determination of whether there was an “objective” risk of misleading investors. This is also the rare case, as is the one described next, where information before the court on a motion to dismiss allowed the court to take into account facts regarding the defendants' thought process.

The U.S. Court of Appeals for the Eighth Circuit recently explicitly recognized that the defendant's assessment of materiality is relevant to scienter.<sup>127</sup> The plaintiff alleged that the defendant corporation had failed to disclose an interruption of operations at a major manufacturing plant, departing from a prior pattern of disclosing similar incidents. When queried about the absence of disclosure, the president of the company allegedly responded that the company did not announce the incident because the anticipated loss for the pending quarter was 2 percent below the low end of the company's previously disclosed projection.<sup>128</sup> The court

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123. *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp.*, 632 F3d 751 (1st Cir. 2011).

124. *Id.* at 757 (emphasis added).

125. *Id.* at 758.

126. *Id.* at 758–59 (emphasis added).

127. *Minneapolis Firefighters' Relief Ass'n v. MEMC Elec. Materials, Inc.*, 641 F3d 1023 (8th Cir. 2011).

128. *Id.* at 1026.

of appeals affirmed the district court's dismissal of the Rule 10b-5 complaint on two grounds. First, there is no duty to provide regular reports of operations interruptions, even where the company had done so in the past.<sup>129</sup> Second, the court held that scienter had not been pleaded, because an inference of scienter was not "as compelling as the more innocent, simpler inference that the defendants did not believe they had a continuing duty to disclose information or, as [the president] stated at the time, MEMC 'didn't think 2% outside of the bottom of the range was material.'"<sup>130</sup> In other words, the corporate officer's state of mind that the undisclosed information was not material was pertinent to assessing whether he, and the corporation, acted with scienter.

Most recently, a district court dismissed with prejudice a complaint where the plaintiff failed to present sufficient allegations that the person whose conduct was the focus of the claim appreciated the risk posed by the conduct in which she was alleged to have engaged. After noting that the corporate defendant's scienter hinged on whether some individual within the organization acted with scienter,<sup>131</sup> the court analyzed the allegations against the individual, Higgins, a marketing department executive. She was alleged to have manipulated financial reporting within that department, which in turn caused the corporation's financial statements to be materially misleading.<sup>132</sup> The court found the allegations that she acted with scienter to be lacking:

There are simply not enough facts to say that Higgins was *obviously aware* her inaccurate accounting could or would eventually result in *Zale* releasing misleading financial statements with *material* errors. Higgins is not an accountant; she is a Marketing Executive who was initially hired as an Administrative Assistant. . . . Given that her background does not suggest an intimate awareness of a large corporation's accounting procedures, the most that may be inferred on her part is an awareness that inaccurate reporting on her end may lead to inaccurate reporting down the line. However, this does not imply Higgins knew what she was doing could result in fraud, and ordinary negligence or even gross negligence are not enough to establish scienter [(citation omitted)]. Thus, the Court finds that the most compelling inference raised by the Amended Complaint is that Higgins neither intended to commit fraud nor was *aware* her actions could lead to *material* errors in *Zale's* financial statements.<sup>133</sup>

It was "unlikely," the court concluded, that "Higgins understood the greater effect of her department's financial reports on *Zale's* financial reports."<sup>134</sup> In other words,

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129. *Id.* at 1028–29.

130. *Id.* at 1030.

131. *Rains v. Zale Corp.*, Nos. 3:09-CV-2133-B, 3:09-CV-2218-B, 3:09-CV-2133-B, 2011 WL 3331213, at \*4, \*6 (N.D. Tex. Aug. 1, 2011).

132. *Id.* at \*2, \*4.

133. *Id.* at \*5 (emphasis added).

134. *Id.* at \*6. Two other factors weighed in the court's decision. First, "[t]here is a substantial likelihood that Higgins was personally motivated to misstate her department's finances to make her department appear within its budget rather than to help *Zale* create inaccurate financial statements to defraud investors. . . ." *Id.* Second, in an enforcement action brought against Higgins the SEC did not charge her with fraud; rather, the claim was based on a violation of the Exchange Act that did not require proof of scienter. *Id.* at \*5–6.

there were insufficient allegations that she *appreciated*, or even objectively should have appreciated, the material impact of what she was alleged to have done.<sup>135</sup>

This line of cases, extending over thirty years, recognizes that the defendant's consideration of, or ability to appreciate, the materiality of a statement is relevant to whether the defendant's failure to make disclosure was reckless in terms of actual or imputed awareness of a risk of misleading investors.

### C. THE PARALLEL WITH "RELIANCE ON COUNSEL"

In assessing whether the defendant's perception—state of mind—regarding the element of materiality is relevant in determining whether the defendant acted with scienter it is useful to consider another indicia of the state of mind that has been considered in addressing scienter. Both case law and commentary acknowledge that reliance on professional advice may be taken into account when assessing the defendant's good faith, which relates to scienter.<sup>136</sup>

Although "[a] good faith reliance on the advice of counsel is not a defense to securities fraud [it is] a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud."<sup>137</sup> Where reliance on counsel is recognized as rebuttal to proof of scienter, the defendant must show that he "(1) made a complete disclosure to counsel; (2) requested counsel's advice as to the legality of the contemplated action; (3) received advice that it was legal; and (4) relied in good faith on that advice."<sup>138</sup> Counsel's advice can be a favorable

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135. This case suggests that the analysis presented by this article applies even where the deception involves an affirmative misstatement, in this case allegedly deliberately false departmental financial reporting, which rendered company-wide statements false and management's statements about those reports false.

136. In addition to the cases discussed in this subsection of this article, see the discussion of *Pittsburgh Terminal* at *supra* note 101.

137. *United States v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996). The court approved the following instruction that was given to the jury:

Reliance on the advice of an attorney may constitute good faith. To decide whether such reliance was in good faith, you may consider whether the Defendant sought the advice of a competent attorney concerning the material fact allegedly omitted or misrepresented, whether the Defendant gave his attorney all the relevant facts known to him at the time, whether the Defendant received an opinion from his attorney, whether the Defendant believed the opinion was given in good faith and whether the defendant reasonably followed the opinion.

*Id.* at 382 n.5 (emphasis added by court of appeals); see also *Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004) ("reliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter").

There is a corresponding relevant factor of reliance on an accountant. See *SEC v. Snyder*, 292 F. App'x 391, 406 (5th Cir. 2008) ("We find no meaningful distinction between the reliance on counsel and reliance on an accountant. Both defensive theories provide an explanation of the defendant's conduct tending to negate the element of scienter. Under both theories, the jury is free to decide for itself whether the facts demonstrate that the defendant acted with scienter in light of the advice he received from his attorneys or accountants. The defendant does not have the burden of proving any 'elements' of the defense before the jury can weigh the defendant's theory of reliance. However, a district court may suggest relevant factors that the jury may consider in its deliberations, such as the instruction approved in *Peterson*.").

138. *SEC v. Savoy Indus., Inc.*, 665 F.2d 1310, 1315 n.28 (D.C. Cir. 1981).

factor for the defendant only if his reliance on it was justifiable.<sup>139</sup> The staff of the SEC acknowledges that there is something known as the “advice-of-counsel defense,” without drawing a distinction between a complete defense and a factor to be taken into account in rebutting an element of the Commission’s case.<sup>140</sup>

As a matter of policy it is sensible to take good-faith reliance on counsel into account at least as a mitigating factor because doing so encourages a person about to make disclosure or to enter into a securities transaction to consult experienced counsel.<sup>141</sup>

Reliance on counsel is most clearly pertinent when the defendant obtained counsel’s assessment of a purely legal matter.<sup>142</sup> One commentator observed:

The Supreme Court’s definition of scienter requires deceptive, manipulative, or fraudulent intent. Deception in the form of an omission, however, is only a violation of the securities laws where there is some sort of legal duty to disclose and where the omission is material. Furthermore, as a general rule, a violation of the law that occurred as part of a relevant transaction is a material fact that must be disclosed. Thus in some circumstances scienter might require knowledge that some aspect of a transaction was illegal, since *otherwise the actor would not know the fact that her omission was material.*

....

... [T]aken as a whole, the case law reveals a pattern it fails to recognize: ignorance of the law is a defense when the sole omitted material fact relates to the contents of the law. Ignorance of the law is only a defense when it negates an element of the offense—in the case of securities fraud, deceptive intent or scienter.

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139. *Papilsky v. Berndt*, No. 71 Civ. 2534, 1976 WL 792, at \*18 (S.D.N.Y. June 24, 1976) (ruling against defendants after trial on claim for breach of fiduciary duty, the court rejected defendants’ reliance on counsel as a defense where “there were numerous indications from authoritative sources that counsel’s advice should not have been treated as dispositive”).

140. U.S. SEC. & EXCH. COMM’N DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL 98 (Aug. 2, 2011), available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf> (“In order to rely on advice-of-counsel as a defense, a party must waive the attorney-client privilege and work product protection to the extent necessary to enable the staff to evaluate the defense. Staff at the Assistant Director level or higher should attempt to explore the possibility of an advice-of-counsel defense with a party’s counsel at an early stage in the investigation. It is important to obtain all relevant documents and testimony at the earliest possible date.”); see also *id.* at 87 (describing the elements of the “defense” substantially identical to those cited at *supra* text accompanying note 138).

141. See *United States v. Bilzerian*, 926 F.2d 1285, 1292 (2d Cir. 1991) (“The potential societal benefit [of consulting counsel] may be great in cases like the one at bar, where defendant seeks legal advice in order to act within the confines of highly complex federal securities laws.”). Asserting reliance on counsel, however, does not come without a cost. Invoking reliance on counsel’s advice entails a waiver of protections from discovery of otherwise privileged communications with that counsel. *Id.* at 1291–92 (stating that if defendant, convicted of securities fraud, had testified at trial to his good-faith belief that his conduct was legal and if this had been based on consultation with counsel, his testimony would have waived the attorney-client privilege as to those communications). This may result in a broader inquiry into the communications between attorney and client than the client-defendant anticipated.

142. See *Steed Fin. LDC v. Nomura Sec. Int’l, Inc.*, 148 F. App’x 66, 69 (2d Cir. 2005) (affirming grant of summary judgment for defendant where scienter was negated by showing reliance on counsel to determine that certain investments had the legal characteristics that defendant had represented); *Howard v. SEC*, 376 F.3d 1136, 1146–47 (D.C. Cir. 2004) (holding that scienter was not established where respondent relied on counsel’s interpretation of SEC rule); *SEC v. Steadman*, 967 F.2d 636,

This limited mistake of law defense is also consistent with the Supreme Court's formulations of scienter and the mistake of law defense. When some alleged deception is based on an omission that involves the contents of the law, ignorance of the law will negate deceptive intent—just as ignorance of the law regarding the ownership of property negates theft when it leads one to wrongly believe that some piece of property is his. . . . Finally, this approach maintains the traditional distinction between ignorance of facts and ignorance of the law.<sup>143</sup>

Under this approach reliance on counsel should also be taken into account when counsel was consulted for advice on whether a fact is material, and thus needs to be disclosed in order for what is otherwise stated not to be a misleading half-truth, even where the omitted fact does not relate solely to the legality of a matter. This is so because materiality is a mixed question of fact and law,<sup>144</sup> so that counsel is often relied on when making disclosure judgments that hinge on materiality. On this topic, another commentator, who was a Commissioner of the SEC at the time, stated:

Advice as to materiality, unlike facts, often involves legal as well as factual judgments. While the businessman ought to be able to judge what is material to investors, and do so more accurately than counsel, in the end judges, not laymen, give meaning to the notion of materiality, and counsel often serve the essential role of framing the business judgment—interpreting the materiality concept as applied to the facts in question, so that the business judgment is rendered in the proper context.

Thus, it is not surprising to find that reliance on counsel's advice as to the immateriality of facts omitted from disclosure has served to support the due care or lack of scienter defense. It should be emphasized, however, that reliance on counsel's view that a particular matter is immaterial will not help where that matter is falsely stated or described in a misleading way in the prospectus or proxy statement, and the defendant knew or recklessly disregarded this fact. It is only in cases of omission where the reliance defense will help when the advice of counsel relates to materiality.<sup>145</sup>

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642–43 (D.C. Cir. 1992) (holding that defendants did not act with scienter where they relied on counsel's incorrect determination that mutual funds were not required to register sales of their shares under state law and thus defendants did not disclose liabilities that could arise from a failure to register).

143. Alexander P. Robbins, *After Howard and Monetta: Is Ignorance of the Law a Defense to Administrative Liability for Aiding and Abetting Violations of the Federal Securities Laws?*, 74 U. CHI. L. REV. 299, 321, 326–27 (2007) (emphasis added) (footnotes omitted). The cited article provides an extensive analysis of the lines of securities law cases that have addressed the extent to which “ignorance of the law” is a defense or a factor rebutting an element of the plaintiffs’ (including the SEC’s) case. With respect to *Howard* (see *supra* notes 137 & 142) in particular, that author concluded:

Howard should have been held liable for aiding and abetting securities fraud if the SEC proved that he either (1) knew the offering violated Rule 10b-9, or (2) realized that a rational investor would find it material that his firm had to purchase shares itself in order to save the offering. The D.C. Circuit held that Howard was ignorant of the law (that is, Rule 10b-9), so the key remaining question would, under this approach, be whether *Howard knew that his deception was material to investors*.

*Id.* at 326 (emphasis added) (footnotes omitted). The emphasized language suggests that appreciation of the materiality of the omitted information could be a factor relevant to scienter.

144. See *supra* text accompanying note 50.

145. Bevis Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 Bus. LAW. 1185, 1195 (1982) (footnotes omitted).

In the seminal article on reliance on counsel in matters arising under the securities laws, the authors observed, “One common situation where reliance on legal advice might be relevant is where a director, before trading, consults his company counsel and is advised that such trading is lawful because his nonpublic knowledge is, in the attorney’s opinion, either immaterial or adequately disseminated.”<sup>146</sup>

These analyses suggest that the defendant’s awareness *vel non* of the materiality of omitted facts bears on whether the defendant acted with scienter. It follows that if the defendant made full disclosure to counsel regarding the facts known to him and sought advice about their materiality, and if counsel advised him that the information was not material and that the defendant could proceed with the proposed conduct without further disclosure, that should be pertinent to the analysis of scienter, even if it does not *necessarily* preclude a finding of scienter.

#### IV. SEC ACTIONS THAT HAVE ADDRESSED THE INTERSECTION OF MATERIALITY AND SCIENTER

The views of the SEC, as the agency that adopted and enforces Rule 10b-5, are often given deference by the courts.<sup>147</sup> It may therefore be instructive to consider what actions the SEC has taken when materiality may be pertinent to scienter.

##### A. SEC RULES AND REGULATIONS

The SEC addressed the relationship of materiality and scienter when it adopted Regulation FD.<sup>148</sup> Although Regulation FD was not adopted pursuant to the SEC’s

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146. Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 133 (1976). It is common for the insider trading policies of public companies to require that directors and senior management preclear any trades in company stock with the company’s general counsel or other designated person. See, e.g., Ari B. Lanin & Daniela L. Stolman, *Building a Better Insider Trading Compliance Program*, INSIGHTS, Mar. 2011, at 9, 14 (recommending including preclearance requirement for all directors, officers, and certain other persons); 18A LANGEVOORT, *supra* note 74, app. F, at app. F-3 (option 3) (providing for prior approval of transactions by all directors, officers, and employees in company securities, as well as in securities of “any other company that you know has or is in the process of establishing a significant business relationship” with the company); WANG & STEINBERG, *supra* note 70, § 13.6.2[B], at 896 (recommending that corporate insider trading policy “should require all officers and directors to consult with the corporate secretary or a designated compliance person before purchasing or selling securities issued by the corporation” (footnote omitted)); *Survey Results: Trading Policies for Outside Directors*, CORPORATECOUNSEL.NET (June 2005), [http://www.thecorporatecounsel.net/survey/Mar06\\_total.htm](http://www.thecorporatecounsel.net/survey/Mar06_total.htm) (reporting that 88.75 percent of eighty public company survey respondents require preclearance of trades by outside directors).

147. See SEC v. Zandford, 535 U.S. 813, 814 (2002) (stating that the SEC’s “interpretation of the statute’s ambiguous text in the context of formal adjudication is entitled to deference”). The Supreme Court has, however, “expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action,” such as where the SEC appears, usually through the Office of the Solicitor General, as an *amicus curiae*. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2304 n.8 (2011); see, e.g., *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2887–88 (2010) (declining to defer to SEC interpretation because the SEC relied on cases of which the Court disapproved). By contrast, the discussion in this section of this article deals with the substance of an element of the SEC’s own rule, Rule 10b-5, and not to any aspect of it that is peculiar to the implied private cause of action for damages.

148. 17 C.F.R. §§ 243.100–243.103 (2011).

rulemaking authority under section 10(b) of the Exchange Act,<sup>149</sup> it nevertheless reflects the Commission's assessment of how to address a situation where someone may be mistaken about the materiality of information. In addition, the adopting release contains an important observation about the meaning of "recklessness" in the Rule 10b-5 context.<sup>150</sup>

In general terms, Regulation FD provides that "when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information."<sup>151</sup> If a public company or someone acting on its behalf "intentional[ly]" discloses material nonpublic information to someone among specified categories of persons, the information must be publicly disclosed simultaneously, and if there is a "non-intentional" nonpublic material disclosure there must be "prompt" public disclosure.<sup>152</sup>

The aspect of Regulation FD pertinent to the scierter question addressed in this article is the prohibition on an "intentional" selective disclosure, which occurs when "the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic."<sup>153</sup> In adopting this aspect of Regulation FD, the SEC stated:

[W]e have made clear that where the regulation speaks of "knowing or reckless" conduct, liability will arise only when an issuer's personnel *knows or is reckless in not knowing* that the information selectively disclosed is *both material* and nonpublic. This

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149. The statutory authority for the adoption of Regulation FD is sections 13 and 15 of the Exchange Act, 15 U.S.C. §§ 78m, 78o (2006 & Supp. IV 2010). Selective Disclosure and Insider Trading, Securities Act Release No. 7881, 65 Fed. Reg. 51716, 51726, 51737 (Aug. 24, 2000) (codified at C.F.R. pts. 240, 243 & 249). Regulation FD states that a violation of Regulation FD shall not, without more, be sufficient to constitute a Rule 10b-5 violation. Regulation FD, Rule 102, 17 C.F.R. § 243.102 (2011). Moreover:

Regulation FD is an issuer disclosure rule that is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act. It is not an antifraud rule, and it is not designed to create new duties under the antifraud provisions of the federal securities laws or in private rights of action.

Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51726 (footnote omitted). For all the reasons stated in this footnote, Regulation FD itself is not an interpretation of Rule 10b-5. For the reasons stated in the text, however, Regulation FD provides useful insights into what the SEC understands reckless conduct to be under Rule 10b-5.

150. See *infra* text accompanying note 155.

151. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51716.

152. Regulation FD, Rules 100-101, 17 C.F.R. §§ 243.100-101 (2011).

153. Regulation FD, Rule 101(a), 17 C.F.R. § 243.101(a) (2011). Scierter is not an element of a violation of Regulation FD, at least where the failure to make disclosure was non-intentional. It may be walking a fine line, however, to conclude that, because Regulation FD is a rule under section 13(a), a violation of which does not entail scierter (*SEC v. McNulty*, 137 F.3d 732, 740-41 (2d Cir. 1998)), an "intentional" violation of Regulation FD does not entail acting with scierter. The elements of the violation are failing to make the required simultaneous disclosure of information "when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic." This is the essence of acting with scierter.

will provide additional assurance that issuers will not be second-guessed on close materiality judgments.<sup>154</sup>

The Commission also stated that “in view of the definition of recklessness that is prevalent in the federal courts, it is unlikely that issuers engaged in good-faith efforts to comply with the regulation will be considered to have acted recklessly.”<sup>155</sup> Restricting the first tier of misconduct in violation of Regulation FD to situations where the person knows, or is reckless in not knowing, that the information is material and advertent to the *Sundstrand* test in that context is fairly read as reflecting the SEC’s view that reckless conduct generally takes into account the defendant’s perception of the materiality of the facts that he has failed to disclose.

Finally on this topic,<sup>156</sup> the SEC stated:

[W]e emphasize that the definition of “intentional” in Rule 101(a) requires that the individual making the disclosure must *know (or be reckless in not knowing)* that he or she would be communicating *information that was both material and nonpublic*. Thus, in the case of a selective disclosure attributable to a *mistaken determination of materiality*, liability will arise only if no reasonable person under the circumstances would have made the same determination. As a result, the circumstances in which a selective disclosure is made may be important. We recognize, for example, that a materiality judgment that might be reckless in the context of a prepared written

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154. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51718 (emphasis added).

155. *Id.* at 51722 (footnote omitted in which *Sundstrand* was cited).

156. One significant SEC antifraud rule does not depend upon the defendant’s awareness of the materiality of the information in question. This rule does not, however, undermine the analysis here.

Rule 14e-3, which prohibits trading while aware of material nonpublic information regarding an impending tender offer, provides that it is unlawful for a person to trade in the securities of the target company if the person “is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from” certain specified categories of persons, including the offeror and the target. 17 C.F.R. § 240.14e-3(a) (2011). This prohibition is not conditioned upon a showing that the person knew or had reason to know the information was material. In adopting the rule, the SEC expressly acknowledged that there was no “know or has reason to know” test applicable to materiality, but did not explain why the rule included such a test for the nonpublic character of the information but not for its materiality. Tender Offers, Securities Act Release No. 6329, 45 Fed. Reg. 60410, 60413–14 (Sept. 12, 1980) (codified at 17 C.F.R. pt. 240). The absence of that element does not inform the issue addressed in this article, however, because Rule 14e-3 is a prophylactic rule which, unlike Rule 10b-5, prohibits *more than* fraudulent conduct. Rule 14e-3 was upheld by the Supreme Court, to the extent necessary to apply the rule to the case before it, stating, “A prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited. . . . [T]he Commission may prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is ‘reasonably designed to prevent . . . acts and practices [that] are fraudulent.’” *United States v. O’Hagan*, 521 U.S. 642, 672–73 (2007) (quoting section 14(e) of the Exchange Act, 15 U.S.C. § 78n(e)).

While this may suggest that scienter is not an element of a civil violation of Rule 14e-3, however, the courts have not so held. *See, e.g., SEC v. Ginsburg*, 362 F.3d 1292, 1297 (11th Cir. 2004) (“[i]n order to establish liability under § 10(b) and § 14(e) of the Securities and [sic] Exchange Act and accompanying Rules 10b-5 and 14e-3, the SEC must prove that Ginsburg acted with scienter”). In the context of a criminal case, any issue regarding scienter is largely mooted by the requirement that the conduct be willful. *O’Hagan*, 521 U.S. at 677 n.23 (rejecting defendant’s argument that Rule 14e-3 improperly omits any scienter requirement, on the ground that section 32 of the Exchange Act requires proof of a willful violation in order to convict someone of a violation of a provision of the Exchange Act or a rule thereunder).

statement would not necessarily be reckless in the context of an impromptu answer to an unanticipated question.<sup>157</sup>

The Commission's statements explaining the meaning of the terms used in Regulation FD, in particular those drawing on judicial interpretations of Rule 10b-5, reflect the Commission's express recognition that a "mistaken determination of materiality" bears on whether a person acted recklessly as recklessness is "prevalent[ly]" understood under the securities laws, referring *explicitly* to recklessness under Rule 10b-5.

When it adopted Regulation FD the SEC also used language suggesting that the corporation's spokesperson's state of mind vis-à-vis materiality is relevant in the context of disclosures to securities analysts.

[A]n issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, *unbeknownst to the issuer*, that piece helps the analyst complete a "mosaic" of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst.<sup>158</sup>

## B. SEC ENFORCEMENT COMPLAINTS

In some Rule 10b-5 insider trading cases filed by the SEC the Commission separately alleges the defendant's knowledge that the facts known to him when he traded were material, as well as nonpublic.<sup>159</sup> This may simply be pleading something as if it were a separate element of the claim when the draftsman does not believe that it is or seeking to emphasize the egregiousness of the defendant's conduct in the particular case.<sup>160</sup> These complaints are noted here in support of an argument that either the SEC believes that knowledge of materiality is an element of scierter or that it is an aggravating factor in the scierter assessment. If either is the case, then lack of knowledge or awareness of materiality should be a mitigating factor in the scierter analysis.

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157. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51722 (emphasis added) (footnote omitted). In one case brought for a violation of Regulation FD, the SEC separately found, as the regulation requires, that the respondent knew that the facts he was selectively disclosing were material. *In re Black*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Admin. Proc. File No. 3-13625, 2009 WL 3047553, at \*4 (Sept. 24, 2009).

158. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51722 (emphasis added). "Unbeknownst" means "without the knowledge of (someone)." NEW OXFORD AMERICAN DICTIONARY 1878 (3d ed. 2010). This was the meaning prior to the adoption of Regulation FD. See WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2483 (1976) ("happening without one's knowledge").

159. I have not done a systemic review, such as a random sampling, of insider trading complaints filed by the SEC, either for a recent period or over time, to determine if there is any pattern to when allegations of knowledge of materiality are included and are not included.

160. If the Commission's rationale for including in its complaint what it may otherwise contend is not an essential element is to underscore the reprehensible character of the alleged violation, this "PR" dimension could be better expressed in the accompanying Litigation Release, where it would not confuse the substantive issues.

Turning to specific cases where the SEC has pleaded in this fashion, in a recent high-profile case<sup>161</sup> involving an alleged law firm associate tipper, the Commission alleged:

63. In each instance of insider trading, Kluger [the alleged tipper] *knew or was reckless in not knowing that the information that he misappropriated from Wilson Sonsini was material* and nonpublic and that he was given access to that information with the expectation that he owed, and would abide by, a fiduciary duty or similar duty of trust and confidence.

.....

78. Kluger, as a lawyer at Wilson Sonsini, *knew or should have known that the information held by Wilson Sonsini regarding the Omniture tender offer had been acquired, directly or indirectly, from the offering entities, the target entities, and/or their advisers or representatives, and that such information was material and nonpublic.*<sup>162</sup>

In another case the Commission alleged that the defendant “knew, or was reckless in not knowing, that the information he misappropriated from his sister regarding the Bare tender offer *was material* and nonpublic.”<sup>163</sup> In an insider trading action solely under Rule 10b-5, the SEC alleged that each of the defendants “knew, or was reckless in not knowing, that the information regarding the

161. See, e.g., Azam Ahmed & Ben Protes, *Deal Lawyer Accused of Running Insider Trading Plan*, N.Y. TIMES, Apr. 7, 2011, at B7 (describing defendant as having been a “a lawyer at three of the most prestigious merger and acquisition law firms in the country”).

162. Complaint ¶¶ 63, 78, SEC v. Kluger, No. 11-cv-01936-KSH (D.N.J. Apr. 6, 2011) (emphasis added), available at <http://www.sec.gov/litigation/complaints/2011/comp21917.pdf>. The action was brought under both Rules 10b-5 and 14e-3. Although, as noted above (*supra* note 156), knowledge of the materiality of nonpublic facts is not an element of a Rule 14e-3 violation, paragraph 78 quoted in the text was in the Rule 14e-3 count of the complaint. There are no comparable allegations of knowledge of materiality in the criminal complaint filed against the same defendants. Criminal Complaint, United States v. Bauer, Mag. No.: 11-3536 (MF) (D.N.J. Apr. 6, 2011), available at [www.justice.gov/usao/nj/Press/files/pdf/2011/Bauer,%20Garrett%20and%20Kluger,%20Matthew%20Complaint.pdf](http://www.justice.gov/usao/nj/Press/files/pdf/2011/Bauer,%20Garrett%20and%20Kluger,%20Matthew%20Complaint.pdf).

163. Complaint ¶ 15, SEC v. Ni, No. CV 11 0708 (N.D. Cal. Feb. 16, 2011) (emphasis added), available at <http://www.sec.gov/litigation/complaints/2011/comp21859.pdf>. The action was brought under both Rules 10b-5 and 14e-3; the quoted allegation was among the allegations relied upon in support of both claims. The defendant settled the case. SEC Files Insider Trading Charges Against Brother of Cosmetics Company Executive, Litig. Release No. 21859 (Feb. 16, 2011), available at <http://www.sec.gov/litigation/litreleases/2011/lr21859.htm>.

For other recent insider trading complaints that contain a specific allegation of the defendant's knowledge, or recklessness in not knowing, of the materiality of nonpublic information, see Complaint ¶ 68, SEC v. Scammell, LA CV 11-6597 (C.D. Cal. Aug. 11, 2011), available at <http://www.sec.gov/litigation/complaints/2011/comp22066.pdf>; Complaint ¶ 39, SEC v. Powell, No. 6:11-cv-161 (W.D. Tex. June 10, 2011), available at <http://www.sec.gov/litigation/complaints/2011/comp21996.pdf>; Complaint ¶ 35, SEC v. Knight, No. 2:11-cv-00973-DGC (D. Ariz. May 17, 2011), available at <http://www.sec.gov/litigation/complaints/2011/comp21972.pdf> (case settled: SEC Charges Former SVP of Choice Hotels International, Inc. and Arizona Realtor with Insider Trading, Litig. Release No. 21972 (May 18, 2011), available at <http://www.sec.gov/litigation/litreleases/2011/lr21972.htm>); Complaint ¶ 18, SEC v. Duffell, No. CV 11-1404 (N.D. Cal. Mar. 24, 2011), available at <http://www.sec.gov/litigation/complaints/2011/comp21899.pdf> (case settled: SEC Charges Former Consultant at Silicon Valley Private Investment Firm with Insider Trading, Litig. Release No. 21899 (Mar. 24, 2011), available at <http://www.sec.gov/litigation/litreleases/2011/lr21899.htm>); Complaint ¶¶ 120–27, SEC v. Carroll, No. 3:11-cv-165-H (W.D. Ky. Mar. 17, 2011), available at <http://www.sec.gov/litigation/complaints/2011/comp-pr2011-69.pdf>.

pending acquisition of [the company whose securities they traded] was confidential, material and nonpublic.”<sup>164</sup>

More commonly there is no allegation in SEC insider trading complaints that the defendant was aware of the materiality of the undisclosed information. For example, the allegations in one recent case regarding a primary violation of Rule 10b-5 stated only that the defendants “learned during the course of their employment the material nonpublic information each conveyed, and each knew, recklessly disregarded, or should have known, that each, directly, indirectly or derivatively, owed a fiduciary duty, or obligation arising from a similar relationship of trust and confidence, to keep the information confidential,” and that they “tipped material nonpublic information to their respective tippee(s) with the expectation of receiving a benefit.”<sup>165</sup> When alleging aiding and abetting a violation of Rule 10b-5 in the same complaint, however, the SEC asserted that the defendants “knowingly or recklessly pass[ed] along information which they knew to be material nonpublic information,”<sup>166</sup> language that again suggests a distinct requirement of knowing that the information is material.

## V. CONCLUSION

In an action under Rule 10b-5 where the claim rests on the defendant’s recklessness, rather than a conscious intent to deceive,<sup>167</sup> the pivotal question is whether the defendant acted with an extreme departure from the standards of ordinary care that presented a danger of misleading buyers or sellers that was either known to the defendant or was so obvious that he must have been aware of it.<sup>168</sup> This necessitates an inquiry into what the defendant perceived, or should have perceived, the risk of misleading to be,<sup>169</sup> albeit in cases where the materiality of the omitted information

164. Complaint ¶¶ 65–69, SEC v. Steffes, No. 1:10-cv-06266 (N.D. Ill. Sept. 30, 2010), available at <http://www.sec.gov/litigation/complaints/2010/comp21678.pdf>. One defendant has settled the case. Litig. Release No. 21678 (Sept. 30, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21678.htm>. The court denied motions to dismiss filed by the other defendants, ruling, among other determinations, that scienter was adequately alleged. SEC v. Steffes, No. 10-CV-6266, 2011 WL 3418305, at \*14 (N.D. Ill. Aug. 3, 2011).

165. Amended Complaint ¶¶ 131–32, SEC v. Longoria, No. 11-CV-0753 (JSR) (S.D.N.Y. Feb. 8, 2011), available at <http://www.sec.gov/litigation/complaints/2011/comp21844.pdf> [hereinafter Longoria Amended Complaint]. This approach is consistent with the SEC’s definition of what it means to trade “on the basis of” material nonpublic information, namely that the “person . . . was aware of the material nonpublic information when the person made the purchase or sale.” Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2011). Two defendants have settled the case. See SEC Obtains Final Judgments on Consent Against Mark Anthony Longoria and Donald Longueuil, Litig. Release No. 22153 (Nov. 15, 2011), available at <http://www.sec.gov/litigation/litreleases/2011/lr22153.htm>.

166. Longoria Amended Complaint, *supra* note 165, ¶¶ 141–42.

167. As discussed earlier, the analysis presented here may also apply when the issue is whether there was a conscious intent to deceive. See *supra* text accompanying notes 91–96.

168. See *supra* text accompanying notes 19–29 and 42.

169. See, e.g., *supra* text accompanying notes 117–19 and 123–26.

is without question the risk will be deemed known to him, or at least he cannot rebut that it was “so obvious he must have been aware of it.”<sup>170</sup>

It is important to stress that it is not whether the *facts* are known (or obvious) to him, but rather whether the *risk* of the *effect* of non-disclosure is known, which directly implicates the materiality of the information. That is, there is no risk of (unlawful) deception if the information is not material, and so if the defendant did not think the facts to be material he had no reason to perceive a risk in making incomplete disclosure, or even non-disclosure.<sup>171</sup> Stated another way, what matters is the potential impact (“misleading”) of the faulty disclosure on investors, which in turn depends on the materiality of the information, because it is only information that it is “substantial[ly] like[ly]” that an investor “would consider important” that is of concern under Rule 10b-5.

This leads to the issue of what arguments can be made on the issue of scienter in those cases where materiality is not beyond question. The cases discussed in Part III.B of this article establish that the defendant’s good-faith lack of appreciation of the materiality of the omission of facts, whether the context is a corporate disclosure or personal securities trading, bears directly on his scienter. This is consistent with the scienter analysis where the defendant claims good-faith reliance on counsel, not only where counsel provides advice on a pure question of law but also where the issue addressed by counsel is a mixed question of fact and law, such as materiality.<sup>172</sup>

Consider this example. The chief executive officer of a public company is about to begin the quarterly earnings conference call. The company is in contract negotiations with its major customer and failure to retain the customer would have a significant adverse financial impact on the company. After assessing the current status of negotiations—current negotiations are routine, no potentially troublesome issues have emerged nor have any threats of non-renewal even been hinted at—and perhaps after conferring with counsel, the CEO concludes, applying the probability-magnitude calculus for future events, that the present state of negotiations is not material.<sup>173</sup> When asked during the call if there are any developments regarding the company’s array of major customers the executive answers that there are none. Within weeks negotiations break down, the customer takes its business elsewhere, this fact is announced, the company’s stock drops, and a Rule 10b-5 suit follows, contending that the company and the CEO made a material misrepresentation with scienter when he denied that there were any developments regarding its customers. Because the executive made a good-faith, i.e., non-reckless, judgment that the situation he did not disclose was not material, the plaintiff should not be able to establish liability under Rule 10b-5. The

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170. See *supra* text accompanying notes 37–42.

171. See *supra* text accompanying note 29.

172. See *supra* text accompanying notes 136–46 (addressing reliance on counsel) and 50 (discussing the mixed nature of the issue of materiality).

173. For this materiality test, see *supra* text accompanying note 54.

CEO did not intend to engage in any Rule 10b-5-type deception, nor was he reckless in failing to perceive the risk that materialized.

Alter these facts a bit. At the time of the earnings conference call the negotiations with the customer are not going as well as hoped, but there has not yet been an impasse, much less a complete parting. Again, the CEO, possibly with the benefit of advice of counsel, makes the judgment that the status of negotiations is not material, applying the probability/magnitude assessment. Here, too, there has been no intent to deceive—the facts were, in the utmost good faith, thoughtfully determined to be immaterial—and it is not accurate to say that the risk of misleading was “obvious.” At some point in the negotiations before the collapse of discussions the deterioration of the relationship undoubtedly becomes material. The question is whether errors in that assessment before materiality reaches the stage of being beyond doubt—even if in hindsight the facts were material when the CEO concluded in good faith that they were not—support a finding of recklessness.<sup>174</sup> I argue that they do not.<sup>175</sup>

The class of cases where the defendant engaged in a thoughtful, thorough assessment of the facts and concluded they were not material may be a minority. It is difficult to posit how a plaintiff’s attorney contemplating whether to file suit, however, would know whether the defendant made a good-faith judgment about materiality when the allegedly deceptive act occurred.<sup>176</sup> In any event, once the true relationship between materiality and scierter is appreciated, more defendants may choose to argue that materiality is not clear-cut, thereby setting the stage for a broader response to the claim that they acted with scierter. The issue of the defendant’s state of mind about the materiality of what is not disclosed should be considered in the defense arsenal of counterarguments.

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174. As observed earlier (*supra* text accompanying note 91), it seems peculiar to say that someone “intended to deceive” when he did not believe that what he failed to say would have been important to investors or when he affirmatively believed disclosure would not have “significantly altered the ‘total mix’ of information.” See *supra* text accompanying note 47.

175. The scenario presented in the text is somewhat complex, dealing with the often difficult assessment of soft information. See *supra* text accompanying notes 84–88. An example of a failure to disclose a hard fact demonstrates the point equally well. The CEO of a pharmaceutical company has been planning for some time to sell company stock. Before selling he learns that a late-stage clinical trial of a drug in development has not gone well and the project will be abandoned. The CEO concludes that the abandonment of this single drug—one among many that are in the company’s research and development pipeline—is not material. Out of an abundance of caution, he confers with fully informed counsel for an assessment of whether this event is material, whether there must be disclosure of this development before the CEO sells some stock. See *supra* text accompanying note 146. Counsel concurs in the CEO’s judgment, and the CEO proceeds to sell his stock. The SEC brings an insider trading claim against the CEO and the court finds, contrary to the CEO’s and counsel’s assessment, that the abandonment of the drug was material. I argue that, notwithstanding the *ex post* judicial determination of materiality, the CEO did not act with scierter when he sold because he did not intend to deceive.

176. The circumstances are different when the SEC files an enforcement action, such as one alleging unlawful insider trading, because that follows an investigation where the SEC has the opportunity to discover the prospective defendant’s thought process, unless he refuses to testify, claiming his rights under the Fifth Amendment.



**Author Biographies for The Business Lawyer, Volume 67, Issue 1, November 2012**

**An Inquiry into the Perception of Materiality as an Element of Scienter Under SEC Rule 10b-5**

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