AN INQUIRY INTO THE PERCEPTION OF MATERIALITY AS AN ELEMENT OF SCIENTER UNDER SEC RULE 10b-5

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by Allan Horwich*

An essential element of a claim under Securities and Exchange Commission (“SEC” or “Commission”) Rule 10b-5 is that the defendant acted with scienter. 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 scienter. Scienter is also at the core of actions by the SEC to seek a remedy for violations of that rule and by the Department of Justice to prosecute violations. One often overlooked issue is the relationship of scienter to the materiality of the deception that lies at the heart of the claim. Recent developments in the law of scienter under

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2 “In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (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 v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008). Where applicable (see infra note 3) 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 scienter); Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 346 (2005) (referring to need to plead loss causation and economic loss).

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 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 147 (2d. ed. 2008).

4 More than a decade ago, this author published an analysis of the relevance in a Rule 10b-5 private damage or government enforcement action of the defendant’s consciousness of the
Rule 10b-5, including the Supreme Court’s decision in *Matrixx Initiatives, Inc. v. Siracusano* and other cases that address the intersection of scienter and materiality, prompt a comprehensive assessment of this relationship.

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 “mental state embracing intent to deceive, manipulate, or defraud.” A specific intent to violate Rule 10b-5 is not an essential element of scienter. To establish a criminal violation of Rule 10b-5, the prosecution must prove that the defendant “willfully” violated 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:

[W]here 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. While others have since addressed the relationship of scienter and materiality (*see infra* text accompanying notes 18-21 and note 74), 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 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).


6 Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 680 F.2d 933, 943 (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.”).
provision.\(^7\) Here, too, there is no requirement to prove that the defendant had a specific intent to violate the law.\(^8\)

The Supreme Court has never decided whether scienter encompasses reckless conduct; it has repeatedly expressly reserved the question for thirty five years.\(^9\) After Hochfelder, however, the courts of appeal uniformly have held that scienter encompasses reckless conduct.\(^10\)

\(^7\) 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”).

\(^8\) See United States v. Dixon, 536 F.2d 1388, 1397 (2d Cir. 1976).

\(^9\) See, e.g., Matrixx, 131 S. Ct. at 1323-24 (“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, 378 n. 4 (1983) (same); Hochfelder, 425 U.S. at 194 n.12 (same).


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 (2011) (“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.”). See also infra notes 10-11 and accompanying text.
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.\footnote{11}

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. \textit{Tellabs}, 551 U.S. at 328-29. \textit{See also In re Vivendi Universal, S.A. Sec. Litig., No. 02 Civ. 05571(RJH)(HBP), 2011 WL 590915, at *13 (S.D.N.Y. Feb. 17, 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 \textit{Tellabs} interpretation of the “strong inference” requirement. \textit{See, e.g.}, Nolfi v. Ohio Kentucky Oil Corp., 562 F. Supp. 2d 904, 910 (N.D. Ohio 2008) (“[\textit{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”). It is unclear what effect this approach would have on the traditional preponderance burden of proof at trial.

\footnote{10} \textit{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.”).

\footnote{11} \textit{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.” \textit{8 Louis Loss, Joel Seligman & Troy Paradis, Securities Regulation} 3688 (3d ed. 2004).

Many courts currently apply this standard of recklessness. \textit{See, e.g.}, City of Dearborn Heights 345 Police & Fire Retirement System v. Waters Corp., 632 F.3d 751, 757 (1st Cir. 2011) (quoting \textit{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); South Cherry Street, LLC v. Hennessee Group 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 Group v. Avaya, Inc., 564 F.2d 242, 267 n.42 (3d Cir. 2009) (same). A recent survey of the different expressions of reckless conduct that is sufficient to satisfy Rule 10b-5 concluded that in the end they essentially state what \textit{Sundstrand} held. Ann Morales Olazábal, \textit{Defining Recklessness: A Doctrinal Approach to Deterrence of Secondary Market Securities Fraud}, 2010 WISC. L. REV. 1415, 1424, 1442.

Some courts apply a higher standard of recklessness as a threshold of liability where the defendant is an outside auditor.
In this seminal 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.”12 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 have forgotten.”13 This interpretation of the test is still applied, at least in the Seventh and Ninth Circuits.14

The reference to a risk that is known or obvious presents alternative formulations – what is actually known or what is obvious. Sundstrand stated that the test for recklessness was an “objective” one,15 but in fact application of the test sometimes entails an inquiry into the actual conduct of the defendant and in particular what the defendant actually knew.16 This is especially

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[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).

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

13 Id. at 1045 n.20.


15 Sundstrand, 553 F.2d at 1045.

16 See infra text accompanying notes 106-111.
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 acted recklessly. This depends upon the potential impact (“misleading”) of the faulty disclosure on investors, which in turn depends on the materiality of the information.\footnote{17}

One recent commentator found the jurisprudence of recklessness under Rule 10b-5 to be “rudderless.”\footnote{18} She proposed an approach that would infer recklessness 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 scienter.\footnote{19} 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.\footnote{20}

\footnote{17} See infra text accompanying notes 32-38.

\footnote{18} Olazábal, supra note 11, 2010 Wisc. L. Rev. at 1421. See id. 1421-29 and 1442-45 for a 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 (“the 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.”).

\footnote{19} See supra note 9 (describing the heightened standard for pleading scienter in private actions for damages).

\footnote{20} Olazábal, supra note 11, at 1420-21 (footnote omitted) (emphasis added).
Under this proposal the inference of scienter may not be appropriate where the materiality of the information was uncertain or borderline.\textsuperscript{21} Thus, whether to infer scienter, at least at the pleading stage, would be driven in part by the significance of the information. The present author parts company with Professor Olazábal principally in concluding that the defendant’s own conception of the materiality of omitted facts that are material is a factor to be weighed in the recklessness analysis,\textsuperscript{22} both at the pleading stage and, more likely, on the merits.\textsuperscript{23}

There is a line of cases, sometimes referring to a company’s “core operations,” where 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.\textsuperscript{24} This applies, however, only where the facts are “so important,” not where the materiality is less clear.\textsuperscript{25}

\textsuperscript{21} 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.”\textit{Id.} at 1432 (footnote omitted).

\textsuperscript{22} The relevance of the defendant’s assessment of materiality is most likely to arise where a material fact has been omitted, rather than where it has been misrepresented, albeit the omission may be in the context of a half truth, the “omission] to state 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). \textit{See infra} text accompany note 123. When the failure to disclose violates Rule 10b-5 was analyzed in Todd R. Davis & Lisa A. Begni, \textit{When is Silence Fraudulent?}, LAW360 (Feb. 8, 2011), http://www.law360.com/securities/articles/223288?utm_source=newsletter&utm_medium=email &utm_campaign=securities (copy on file with author), in which some of the cases discussed later were discussed.

\textsuperscript{23} It would be an unusual case where the plaintiff would have facts regarding the defendant’s actual consideration of the materiality of undisclosed facts and would choose to plead them. Thus, the defendant’s actual consideration of the materiality of an omitted fact is far more likely to be addressed on the merits.

\textsuperscript{24} Berson v. Applied Signal Technology, Inc., 527 F.3d 982, 987-889 (9th Cir. 2008). \textit{See also} Institutional Investors Group v. Avaya, 564 F.3d 242, 270 (3d Cir. 2009) (holding that chief
The decision of the Seventh Circuit Court of Appeals on the Supreme Court’s remand in *Tellabs* applied a variation of this approach. In first reversing the district court’s grant of the motion to dismiss the corporate defendant, 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 dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.²⁶

- 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 “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. General Growth Properties, 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).

Professor Olazábal maintains that her approach differs from the core operations doctrine. Olazábal, supra note 11, 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.


²⁶ Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008).
Applying a similar analysis to the claim against the company’s chief executive officer, 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.

This explanation begs the question of the relevance of the defendant’s awareness or appreciation of the “gravity” of the facts, presumably meaning facts that are especially material.

Especially after the Tellabs direction to consider the totality of the complaint in assessing whether scienter has been plead, the application of the core operations doctrine is very case-specific. Accordingly, when looking at the entirety of a complaint courts may hold that sheer magnitude of the alleged deception alone is not sufficient to allege scienter. As assessment of

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27 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.”)

28 Id. at 704.

29 Tellabs, 551 U.S. at 322, 325.

30 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. See, e.g., Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 1000-1002 (9th Cir. 2009) (upholding dismissal of complaint and summarizing the narrow scope of the core operations inference).

31 See, e.g., 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 the magnitude of the misrepresentation or omission, in light of the defendant’s position within the corporation. See supra text accompanying note 20.
how these tests for scienter apply requires an understanding of the concept of materiality under Rule 10b-5.

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

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.\(^{32}\) 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.”\(^{33}\)

“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.”\(^{34}\) Materiality is a mixed question of fact and law.\(^{35}\) Whether a fact is immaterial, however, can be decided by a

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\(^{33}\) Basic, 485 U.S. at 231-32 (quoting TSC, 426 U.S. at 449).

\(^{34}\) 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”).

\(^{35}\) 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.”).
court on a motion to dismiss or for summary judgment.\textsuperscript{36} Courts rarely find materiality as a matter of law where the issue is contested.\textsuperscript{37}

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.'”\textsuperscript{38} In \textit{Basic}, the Court held only that the probability/magnitude test applies to merger negotiations.\textsuperscript{39} The test is now routinely applied to a wide array of disclosures that have a forward-looking element to them. The case from which \textit{Basic} drew the probability/magnitude test involved an evolving situation regarding the discovery of minerals.\textsuperscript{40} The test has since been

\textsuperscript{36} \textit{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) (Alito, J.); SEC v. Siebel Systems, 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. \textit{See} Allan Horwich, \textit{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).

\textsuperscript{37} \textit{Cf.} Wilson v. Great American 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.”).

\textsuperscript{38} \textit{Basic}, 485 U.S. at 238 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).

\textsuperscript{39} \textit{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.”).

\textsuperscript{40} \textit{Basic}, 485 U.S. at 238, citing \textit{Texas Gulf Sulphur}, 401 F.2d at 849.
applied in cases involving the riskiness of assets owned by a financial firm, a potential corporate restructuring, contingent financing, plans to oust a member of the board of directors, plans to construct a new manufacturing facility, and entry into a new sales contract, among many contexts.

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 . . . .” 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 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

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43 Great American Indus., 855 F.2d at 993 (reversing bench trial judgment in favor of defendants and ordering entry of judgment for plaintiff, holding that information was material).

44 In re General 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).

45 Milton v. Van Dorn Company, 961 F.2d 965, 969-71 (1st Cir. 1992) (Breyer, J.) (affirming summary judgment for defendants, holding that information was not material).

46 Gay v. Axline, 23 F.3d 394 (Table), 1994 WL 159426, at *6-8 (1st Cir. 1994) (affirming bench trial judgment in favor of defendants that information was not material, albeit on different analysis than applied by the district court).

47 For other examples, see J. ROBERT BROWN, JR., THE REGULATION OF CORPORATE DISCLOSURE § 505.[3][c], at 5-77 (3d ed. 2011).

48 TSC, 426 U.S. at 450.
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.49

Another commentator has 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.”50 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.’”51

The probability/magnitude test52 is particularly knotty. This is a “highly fact-dependent” test,53 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

49 Sauer, supra note 32, 62 BUS. LAW. at 323 (footnotes omitted). See also Hodges, supra note 4, 30 SEC. REG. L. REV. at 36-37 (advocating a broad interpretation of materiality while also discussing how implementation of Staff Accounting Bulletin No. 99 - Materiality, supra note 32, “is undeniably fraught with ambiguity, uncertainty, and unpredictability”).


51 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, 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.

52 See supra text accompanying note 38.

53 Basic, 485 U.S. at 239 n.16.
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.\textsuperscript{54}

In practice this test is very difficult to apply before the fact,\textsuperscript{55} with a significant risk of hindsight
bias when a case is litigated.\textsuperscript{56}

See also Larry D. Soderquist & Theresa A. Gabaldon, Securities Law 136 (4th ed. 2011)
(“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.”).

\textsuperscript{55}See, e.g., Brown, supra note 47, at § 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 Langevoort, Rereading Cady. Roberts: The Ideology and Practice of Insider
Trading Regulation, 99 Colum. L. Rev. 1319, 1337 (1999) (“in 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).

\textsuperscript{56}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 consider-able obstacle to the fundamental
task in securities regulation of sorting fraud from mistake.

Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort, Fraud by Hindsight, 98 Nw. U. L.
Rev. 773, 774 (2004) (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 of
the hindsight bias reveal that knowing the outcome makes the antecedents seem more significant
than was actually the case.”) (footnote omitted).
Newly minted lawyers are sent into the professional world with fair warning of the difficulty of assisting their clients in making judgments about materiality. One leading casebook states, “Outside of litigation, considering whether an item is material and thus must be disclosed is frequently an ulcerating experience.”57 Two other casebook authors state, “Unfortunately, determining whether a particular morsel of information is material is often an uncertain process.”58 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.”59

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.60 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, that the event reports were material under the securities laws only if they were “statistically signiﬁcant.”61 Following the *Basic* “total mix”


59 SODERQUIST & GABALDON, supra note 54, at 72.

Some may seek to escape this conundrum by applying the conservative watchword “when in doubt, disclose.” This seems simple, but it is hardly practical, much less the foundation for liability when not followed.

60 Matrixx, 131 S.Ct. at 1313, 1323.

61 Id. at 1318-19.
test, 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.” The Court then held that the allegations of the complaint “raise a reasonable expectation that discovery will reveal evidence’ satisfying the materiality requirement.” The analysis leading to this conclusion required a review of all of the information alleged to have been available to the defendants, all as matched against the (allegedly misleading) statements made by Matrixx.65

It is often said that materiality can be inferred from the defendant’s own actions. This approach, however, is not dispositive of the question of materiality. One commentator has criticized this approach to determining materiality.

62 See supra text accompanying note 33.
63 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.

131 S. Ct. at 1321 (footnote omitted) (emphasis added).

64 Matrixx, 131 S. Ct. at 1323 (quoting Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 556 (2007)).
65 131 S. Ct. at 1322-23.
66 See, e.g., SEC v. Maio, 51 F.3d 623, 637 (7th Cir. 1995) (holding that trading while aware of information “tends to show” that the information was material); Rubinstein v. Collins, 20 F.3d 160, 170 n.39 (5th Cir. 1994) (observing that trading prior to disclosure is “indicative” of materiality); Rorech, 720 F. Supp. 2d at 412 (“courts often look to the actions of those who were
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.68

For this and other reasons, an irrebuttable presumption would improperly beg the question of cause and effect. Apart from whether the investor in question is the “reasonable investor” whose perspective is the measure of the materiality of information,69 it avoids the fundamental factual issue of whether learning the information resulted in the trade or was just one of many factors – or no factor at all – resulting in a trade at that time.70 (This of course applies only where the person actually knew the information, which may be contested.) That is, a person could trade for privy to the information in determining materiality”). See William K. S. Wang & Marc I. Steinberg, Insider Trading § 4.2.2, at 112 n. 54 (3d ed. 2010) (collecting cases).

67 See, e.g., Abromson v. American Pacific Corp., 114 F.3d 898, 903 n.3 (9th Cir. 1997) (“the presence of insider sales is at most probative of materiality”); Chelsea Associates v. Rapanos, 527 F.2d 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.”).

68 Bainbridge, supra note 54, at 36.

69 See supra text accompanying notes 32-38.

70 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, Release No. 33-7881, 65 F.R. 51716, 51727 (Aug. 24, 2000). 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.
any number of reasons unrelated to the material investment merits of the particular security. 71 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 trades. It is tenuous to infer that, because X traded on Day 40, X was a material fact. The inference would be much stronger had the trade occurred on Day 1 or even Day 10.

The need for caution in inferring materiality from the fact of trading has a parallel with the inferring scienter from the act of trading. Although trading by insiders at a time when they are alleged to have known material nonpublic material information may support an inference of scienter, the act of trading does not inevitably lead to that inference, that there was an intent to deceive. Whether trading by insiders is indicative of scienter, a motive deliberately to withhold the (material) truth from the public, depends on the character of the trading, such as the amount

71 See, e.g., 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & 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 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 in United States v. Martha Stewart, at ¶ 3 (Feb. 19, 2004), reprinted in MARC I. STEINBERG, SECURITIES REGULATION 657-59 (Rev. 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.
of shares or dollars 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.\footnote{72}{Mississippi Pub. Emps.’ Ret. Sys. v. Boston 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 plaintiff’s 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 Boston Scientific Corp. Sec. Litig., 708 F. Supp. 2d 110, 127 (D. Mass. 2010), appeal docketed, No. 10-1663 (1st Cir. June 11, 2010). See also Metzler Inv. GMBH v. Corinthian Colleges, 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% of his holdings during the class period, and many sales were in a manner consistent with pre-class period sales). On pleading scienter by alleging the defendant’s insider trading, see PERINO, supra note 9, § 3.01 D.5.b, at 3-124 to -134.}

As explained earlier, a defendant acts recklessly in violation of Rule 10b-5 if he knows of a danger of misleading investors or the risk of misleading investors is so obvious he must have been aware of that risk.\footnote{73}{See supra text accompanying notes 11-16.} This actual or inferred awareness of a risk seems to be dependent upon the extent to which the information he knows is material, so that he does, or should reasonably, understand that non-disclosure may adversely influence investors.\footnote{74}{The interdependence of scienter and materiality at the pleading stage is not a new insight. A number of years before Professor Olazábal’s analysis (supra text accompanying notes 18-21), several commentators observed:

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.} 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.\(^{75}\) The test is not just *more probable than not* that the investor would consider the fact important, nor even substantially likely that the investor *might* consider it important.\(^{76}\)

The next section of this article discusses cases where the defendant’s awareness *vel non* of the *materiality* of the undisclosed information did in fact bear on whether he acted with scienter in not disclosing those facts.

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Gulati, Rachlinski & Langevoort, *supra* note 56, 98 NW. U. L. REV. at 791. The thesis of this Article is that a defendant’s actual assessment of materiality at the time the wrong was alleged to have occurred is in fact sometimes an important element of the scienter analysis, not that materiality is a proxy for, or ground to infer, intent, though that may sometimes be the case where materiality is indisputable *ex ante*.

\(^{75}\) *See supra* text accompanying note 32.

\(^{76}\) These may be fine distinctions, but one very important aspect of *TSC*, 426 U.S. at 446-47 (1976), 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 Sciences Corp., 507 F.2d 485, 489 (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] to the traditional and less speculative common law language of the objective test") (quotation marks and citations omitted), *with SEC v. First American Bank and Trust Company*, 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*).
III. RECENT CASES THAT ADDRESS THE INTERSECTION OF SCIENTER (RECKLESSNESS) 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 acted with an intent to deceive – including acting recklessly – in making a material misrepresentation or making a statement that omits material facts necessary in order to make the statements made not misleading. In many cases, the materiality of the information that was misrepresented, or that was not disclosed, is clear. 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 is aware is 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 Background for an Analysis of Scienter under Rule 10b-5 – A Digression into the Common Law

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

77 This Article focuses on material deception through false statements or through silence when there is a duty to speak and, most especially, 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 Ind. v. Green, 430 U.S. 462, 476-77 (1977)), Rule 10b-5 also reaches deceptive non-verbal conduct. See Stoneridge, 552 U.S. at 158; and 7 LOSS, SELIGMAN & PARADES, supra note 11, at 3536-41 (3d ed. rev. 2003) (discussing non-verbal acts, such as a broker’s unauthorized trading in a customer account).

78 See, e.g., supra text accompanying notes 24-31 (discussing the core operations doctrine).
discourse one would not say, “I intended to deceive her by failing to disclose something I did not expect would influence her decision.” In that situation there is no intent to deceive.\textsuperscript{79}

This is in accord with many common law precedents. 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 \textit{Hochfelder} interpreting the operative words of Section 10(b) of the Exchange Act.\textsuperscript{80} One widely-accepted interpretation of the common law of fraud and deceit is that

\textsuperscript{79} Consider the following:

For a \textit{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.

\ldots

One cannot guess how a word functions. One has to \textit{look at} its use and learn from that.

\textbf{Ludwig Wittgenstein, \textit{Philosophical Investigations} § 43, at 20, and § 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.

\textbf{Bryan A. Garner, \textit{A Dictionary of Modern Legal Usage} 457 (2d ed. 1995).}

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 \textit{Fowler v. Harper, Fleming James, Jr. & Oscar S. Gray, Harper, James and Gray on Torts §§ 7.1-7.3 (3d ed. 2006)}.

\textsuperscript{80} In \textit{Hochfelder} 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. 425 U.S. at 203-204. It is likewise appropriate to consider what was meant by “intent to deceive” at that time. It is useful to recall the holding of \textit{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.” 425 U.S. at 193 & n.12.
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. 81

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) (“[a]n intention to induce the plaintiff to act or refrain from action in reliance upon the misrepresentation” is an element of 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) (“[I]f a falsehood be knowingly told, with an intention that another person should believe it to be true,

81 RESTATEMENT (SECOND) OF TORTS § 525 (1977). This is substantially the same as the original version of the Restatement, with the changes coming 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 (Scintere)” 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 RESTATEMENT (SECOND) OF TORTS § 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.”)
and act upon it, . . . the party telling the falsehood is responsible in damages in an action for deceit . . . .”).

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.

82 United States v. Kenrick, 221 F.3d 19, 29 (1st Cir. 2000) (holding that intent to deceive, but not intent to harm, is element of crime of federal bank fraud). Kenrick drew on the common law precedents in order to discern the meaning of the federal mail fraud statute, 18 U.S.C. 1344, when it was enacted. While not all courts have followed Kenrick’s interpretation of the mail fraud statute (see, e.g., United States v. Everett, 270 F.2d 986, 990 (6th Cir. 2001)), Kenrick’s summary of the common law is sound.

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. “[T]he 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), s 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.


83 In the context of bank fraud “material” has a broader meaning than the “reasonable person” test under the securities laws. See supra text accompanying notes 32-34. 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
B. Rule 10b-5 Cases Recognizing the Relevance of Materiality to Scienter

If, as discussed above, 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% 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.” To put the issue in the typical terminology of recklessness, the “danger of misleading” was not “obvious.” A claim was held not to allege scienter where “the accounting irregularities Plaintiffs allege in this case are significantly less egregious in nature and magnitude [that those in a case cited by 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.”

This author’s earlier article on this topic cited cases that had suggested that, wholly apart from the objective test of what was “obvious,” 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. In action, although a reasonable man would not so regard it.” Neder v. United States, 527 U.S. 1, 22 n.5 (1999) (citing RESTATEMENT (SECOND) OF TORTS § 538 (1977)).

84 See supra text accompanying notes 24-31.


86 See supra text accompanying notes 11-17.

87 PR Diamonds, 364 F.3d at 685-86.

88 Horwich, supra note 5, 55 BUS. LAW. at 1035-37. 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 Hochfelder, 425 U.S. at 197, 211 n.31). 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.

In SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983) (en banc), 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 . . . .” (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 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) (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 167-68 & 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., 680 F.2d at 943. There would be no scienter, however, if the defendants relied on counsel 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 112-126.) At least one court has read Pittsburgh
the nearly dozen years since that article, a number of other cases have addressed the relevance of
the defendant’s consciousness of, or inattention to (when not willfully ignorant), the materiality
of the challenged statement in the context of the determination of scienter.\footnote{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 falseness. See, e.g., Gebhart, 595 F.3d at 1042 (“although 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”). 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 a statement that was false or incomplete. In many cases, for example,
the materiality of the statements is beyond question. See supra text accompanying notes 24-31
(discussing core operations cases). At the same time, 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,\footnote{\textit{See supra} note 9.} the Tenth Circuit Court of Appeals took materiality into account in assessing the
sufficiency of allegations of scienter.\footnote{\textit{See supra} note 9.} 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

\textit{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
(D.D.C. May 23, 1985). In so ruling, the court recognized that the plaintiff need not prove that
the defendant thought his actions were illegal. \textit{Id.}

These earlier cases suggest that the defendant’s own lack of awareness (or appreciation)
of materiality – though it might have been “obvious” to others, such as the “reasonable man” –
diminishes a claim of acting with scienter.

\footnote{City of Philadelphia v. Fleming Companies, Inc., 264 F.3d 1245, 1248 (10th Cir.
2001).}
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.92

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.93

Dismissal of the complaint was affirmed for this and other reasons.94 Here 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.”95

92 Id. at 1261.

93 Id. at 1263-64 (emphasis added).

94 Id. at 1270.

Fleming Companies, 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 from, or recklessly
disregarded the importance of those facts”). While the facts alleged in that case 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.” Wilson, 195 F.
Supp. 2d at 639-40. Moreover, even if company executives were alleged to have been aware of
problems, plaintiffs failed to allege “specific facts showing that Defendants either knew or
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. 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]

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.96

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 and not disclosed.

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should have known that any [amounts in question], once captured, would reveal a material difference” in expenditures compared to what had been estimated. Id. at 642.

The cases discussed to this point predate the Supreme Court’s decision in *Tellabs* in 2007, which construed the heightened pleading standard for scienter. That decision did not change the consideration of materiality when assessing scienter. 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, the Court did not find sufficiently plausible defendants’ proffered inference from the facts alleged that defendants did not disclose the adverse event reports regarding the drug they sold because they “believed they were too few . . . to indicate anything meaningful about adverse reactions” to the drug. 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.”

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” sounds more like a deliberate decision than the recklessness the Court stated it was addressing, the

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97 See supra note 9.


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

100 131 S. Ct. at 1324-25 (emphasis added) (quoting *Tellabs*, 551 U.S. at 323, 324).

101 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
core 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 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, 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.”

Turning to the lower courts after *Tellabs*, in the Second Circuit Court of Appeals the scienter standard continues to include consideration of strong circumstantial evidence of conscious misbehavior or recklessness. Where facts allegedly omitted were marginally material at most, “the duty to disclose [the omitted fact] was not so clear” and accordingly “defendants’ recklessness cannot be inferred from the failure to disclose.” In a more recent

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102 *Id.* at 1316.

103 *Id.* at 1325.

104 *Kalnit* v. Eichler, 264 F.3d 131, 142 (2d Cir. 2001) (pre-*Tellabs*); ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 87, 202-203 (2d Cir. 2009) (post-*Tellabs*).

105 *Kalnit*, 264 F.3d 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).
case, 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.\textsuperscript{106}

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.\textsuperscript{107} Most of the opinion just quoted from, however, appears to focus on the defendants’ awareness of the falsity of their statements rather than on the perception of the materiality of the statements.

In a decision by the First Circuit Court of Appeals,\textsuperscript{108} 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 F.3d 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

\textsuperscript{106} ECA, 553 F.3d at 202-203.

\textsuperscript{107} Platforms Wireless, 617 F.3d at 1093-94 (9th Cir. 2010) (affirming summary judgment for plaintiff).

\textsuperscript{108} Waters Corp., 632 F.3d 751.
defendants acted with the requisite intent or extreme recklessness in not disclosing the fact.\textsuperscript{109}

Further, “the key question” is not whether defendants had knowledge of certain undisclosed facts, but rather whether defendants knew or should have known that their failure to disclose those facts presented a danger of misleading buyers or sellers.\textsuperscript{110} 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.”\textsuperscript{111}

This line of cases extending over thirty years recognizes that the materiality of an omitted 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 would be useful to consider what other indicia of the state of mind have been considered by courts in addressing scienter. Both caselaw and commentary acknowledge that reliance on professional

\textsuperscript{109} Id. at 757 (emphasis added).

\textsuperscript{110} Id. at 758.

\textsuperscript{111} Id. at 758-59 (emphasis added).
advice may be taken into account when assessing the defendant’s good faith, which relates to scienter.\textsuperscript{112}

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.”\textsuperscript{113} (The staff of the SEC acknowledges that there is something known as the “advice-of-counsel defense, though it does not identify what the elements are.\textsuperscript{114}) Where

\textsuperscript{112} In addition to the cases discussed in this subsection of this Article, see the discussion of Pittsburgh Terminal, supra note 88.

\textsuperscript{113} 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.

\textit{Id.} at 382 n.5 (emphasis added by court of appeals). \textit{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. \textit{See} SEC v. Snyder, 292 Fed. Appx. 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 \textit{Peterson}.

\textsuperscript{114} SEC Division of Enforcement, \textit{ENFORCEMENT MANUAL} 99 (Feb. 8, 2011), http://www.sec.gov/divisions/enforce/enforcementmanual.pdf:
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.” Counsel’s advice can be a favorable factor for the defendant only if his reliance on it was justifiable.

As a matter of policy it is sensible to take good faith reliance on counsel into account because doing so encourages a person about to make disclosure or to enter into a securities transaction to consult experienced counsel. Asserting reliance on counsel, however, does not come without a cost. Invoking reliance on counsel’s advice entails a waiver of otherwise 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.


116 Papilsky v. Berndt, No. 71 Civ. 2534, 1976 WL 792, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,627, at 90,133 (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”).

117 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.”).
privileged communications with counsel. This may result in a broader inquiry into the communications between attorney and client than the client-defendant anticipated.

Reliance on counsel is most clearly pertinent when the defendant obtained counsel’s assessment of a purely legal matter. 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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118 See Bilzerian, 926 F.2d 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 client, his testimony would have waived the attorney-client privilege as to those communications).

119 For a discussion of the possible subject matter waiver when a client waives the attorney-client privilege with respect to specific communications, see Edward J. Imwinkelried, The New Wigmore – A Treatise On Evidence § 6.12.7 (2d ed. 2010) (discussing “fairness test, a broad version of the subject matter test, and a narrow version of the latter test” when the privilege has been waived as to a specific communication).

120 See Steed Finance LDC. v. Nomura Securities Intern., Inc., 148 Fed. Appx. 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, 376 F.3d at 1146-47 (holding that scienter was not established where respondent relied on counsel’s interpretation of SEC rule); SEC v. Steadman, 967 F.2d 636, 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 did not disclose liabilities that could arise from a failure to register).
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.\textsuperscript{121}

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,\textsuperscript{122} so that counsel is often relied on when making disclosure judgments. On this topic, one commentator has 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,

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\textsuperscript{121} Alexander P. Robbins, \textit{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) (footnotes omitted) (emphasis added). 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 plaintiff’s (including the SEC’s) case. With respect to \textit{Howard} (supra note 115) 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.

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

\textsuperscript{122} \textit{See supra} text accompanying notes 35-37.
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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.123

In the seminal article on reliance on counsel in matters arising under the securities laws, written before Hochfelder clarified the standard of culpability under Rule 10b-5, the authors presented an “on the one hand, on the other hand” perspective.

A similar but distinguishable situation occurs when the defendant knows the statement is misleading but, based on his attorney’s advice, believes that the inaccuracy is not material. Again, this may be regarded as either factual or legal advice – the attorney advises either that the false statement is not important enough to affect investment decisions or that the statement would not be considered material by a court. In this case, however, the distinction may not matter. Since defendant knows the statement is misleading, he would appear to lack good faith. Only where knowledge of materiality is deemed an indispensable element of bad faith, as it is under certain circumstances, would defendant’s knowledge that the statement is misleading, to whatever extent, not result in his being held liable. . . .

Certainly the lawyer’s expertise on this factual issue of materiality is arguable. The client might well be more justified in relying on a security analyst, or on his own experience, for what is essentially a nonlegal judgment. A court reasoning in this way may reject reliance on counsel as a defense under a due care standard on the basis that the defendant should have known by exercising his own judgment that the fact in question was material. Under a good faith standard, the reasonableness of defendant’s reliance, of course, would not be relevant. Thus if

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123 Bevis Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 Bus. Law. 1885, 1195 (1982) (footnotes omitted). In the present author’s personal experience in private practice, clients often rely heavily on counsel’s judgment on the materiality of a fact, whether deciding what information needs to be disclosed in the context of other mandated disclosures or in deciding whether or not it is permissible to trade securities when the information in question known to the client is nonpublic.
materiality were part of the good faith requirement, reliance on counsel’s advice here might be a defense proving good faith, if not due care. Since knowledge of materiality would, however, seem to be evidence of bad faith, reliance in this situation is probably not a defense under either standard. Yet, because these issues of materiality arise frequently, a securities lawyer is more likely than a layman to have a “feel” for the adequacy of a press release, even as to factual matters or impact on investors.124

Insofar as the need to rely on counsel for materiality judgments is concerned, the authors note – writing before the meaning of “materiality” was clarified in TSC and Basic – “For example, a layman would not even be aware of the various verbal formulations of materiality in terms of whether investors ‘should,’ ‘might,’ ‘may,’ or ‘would’ be affected and whether materiality is to be measured by the impact of the information on the speculative, conservative, average, or other investor.”125 More directly pertinent to the issues addressed in this Article, the authors stated, “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.”126 More recent scholarship has noted the importance of participation by counsel in determining questions of materiality.127


125 Id. at 131 n.552. This difficulty remains after TSC and Basic. See supra text accompanying notes 53-51.

126 Hawes & Sherrard, supra note 124, 62 VA. L. REV. at 133. In fact, it is common for the insider trading policies of public companies to require that directors and senior management pre-clear 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, 25 INSIGHTS No. 3, 9, at 14 (Mar. 2011) (recommending including preclearance requirement for all directors, officers and certain other persons); 18A LANGEVOORT, supra note 71, 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 66, at § 13.6.2[B], at 896
The two preceding analyses may be flawed in one respect. They both draw a distinction between what might be called a pure omission, that is, a failure to disclose altogether, and a statement that is misleading, where it is known to be misleading. A misleading statement is actionable under Rule 10b-5 only if it is materially deceptive, so that a statement that is false, but in an immaterial way, should no more give rise to a claim of scienter than a complete failure to disclose something that is not material, where if the information were material, there would have been a duty to disclose it. The concept of “immaterially misleading” may be an oxymoron, but if the thought sought to be conveyed by these commentators is that one acts with scienter, an intent to deceive, when one utters an immaterially false statement, that is incorrect. If the point sought to be made is that uttering a statement known to be “misleading” is always wrongful because a statement is misleading only if it influences the hearer’s decision, then the analysis is consistent with the argument in this Article that the purpose of the disclosure is a fundamental inquiry.

These analyses suggest that the defendant’s awareness vel non of the materiality of omitted facts, which may arise when he is ignorant of the legal consequences of some act whether or not that act itself has been disclosed, 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

(recommending that corporate insider trading policy “should require all officers and director to consult with the corporate secretary or a designated compliance person before purchasing or selling securities issued by the corporation”) (footnote omitted); TheCorporateCounsel.net, Survey Results: TRADING POLICIES FOR OUTSIDE DIRECTORS, http://www.thecorporatecounsel.net/survey/Mar06_total.htm (June 2005) (reporting that 88.75% of 80 public company survey respondents require preclearance of trades by outside directors) (on file with author).

127 See Cox, Hillman & Langevoort, supra note 57, at 585-86 (“Because the materiality concept is such a workhorse in securities regulation, learning to apply it is probably the most valuable skill securities lawyer can acquire.”); see also supra notes 57-59 (discussing role of counsel in making determinations of materiality).
information was not material and that 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 entitled to deference by the courts. It is therefore useful 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. 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.” If a

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130 Selective Disclosure and Insider Trading, supra note 70, 65 F.R. at 51716. By its terms, a failure to comply with 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 F.R. at 51726 (footnote omitted). Thus, Regulation FD itself is not an interpretation of Rule 10b-5. Elsewhere in the release that promulgated
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 an “non-intentional” nonpublic material disclosure there must be prompt public disclosure.\(^\text{131}\) In adopting 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 will provide additional assurance that issuers will not be second-guessed on close materiality judgments.\(^\text{132}\)

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.”\(^\text{133}\) Finally on this topic, 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 statement would not necessarily be reckless in the context of an impromptu answer to an unanticipated question.\(^\text{134}\)

Regulation FD, however, the SEC expressly offered an interpretation of the concept of recklessness under Rule 10b-5. See infra text accompanying note 133.

\(^{131}\) Regulation FD, Rules 100-101, 17 C.F.R. §§ 243.100 & 101 (2011). Disclosure is “intentional” 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.” Regulation FD, Rule 101(a), 17 C.F.R. § 243.101(a) (2011).

\(^{132}\) Selective Disclosure and Insider Trading, supra note 70, 65 F.R. at 51718 (emphasis added).

\(^{133}\) Id. at 51722 (footnote omitted in which Sundstrand was cited).

\(^{134}\) Id. at 51722 (footnote omitted) (emphasis added). In one case brought for a violation of Regulation FD the SEC separately found, as the regulation requires, that the respondent knew
These statements reflect the Commission’s 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 the use of that term in proceedings under Rule 10b-5.

When it adopted Regulation FD the SEC also noted 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.135

In other words, whether the speaker is culpable depends on whether or not she was actually aware (the opposite of “unbeknownst”)136 that she was supplying a piece of the analyst’s puzzle that would transform an array of immaterial items into a material whole.137

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

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that the facts he was selectively disclosing were material. In the Matter of Christopher A. 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, at ¶ 21 (Sept. 24, 2009).

135 Selective Disclosure and Insider Trading, supra note 70, 65 F.R. at 51722 (emphasis added).

136 “Unbeknownst” means “without the knowledge of (someone).” NEW OXFORD AMERICAN DICTIONARY 1878 (3d ed. 2010). This was the meaning when Regulation FD was adopted. See WEBSTER’S THIRD NEW INT’L DICTIONARY 2483 (1976) (“happening without one’s knowledge”).

137 A full discussion of the mosaic theory of materiality is beyond the scope of this article. For brief discussions of that theory, see 18 LANGEVOORT, supra note 71, at § 11.5, at 11-17 to -18; WANG & STEINBERG, supra note 66, at § 4.2.3[D].
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.\(^\text{138}\) In contrast to Regulation FD, this
prohibition was not conditioned upon a showing that the person knew or had reason to know the
information was material. Rule 14e-3, however, is a prophylactic rule that goes beyond
fraudulent conduct.\(^\text{139}\)

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.\(^\text{140}\) Thus, in a recent high-profile case involving an alleged law firm associate
tipper, the Commission asserted:

63. In each instance of insider trading, Kluger [the 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

\(^{138}\) 17 C.F.R. § 240.14e-3(a) (2011). 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
12, 1980).

\(^{139}\) 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
(2006)).

\(^{140}\) The author has not done a systemic review, or even random sampling, of insider
trading complaints filed by the SEC, either for a recent period or over time. The import of the
material that follows is merely to note that from time to time the SEC pleads insider trading
claims under Rule 10b-5 in a manner that is consistent with the thesis of this Article.
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.\footnote{Complaint, SEC v. Kluger et al., No. 11-cv-01936-KSH (D.N.J. Apr. 6, 2011) (emphasis added), \url{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 (\textit{supra} text accompanying notes 132-135), 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. United States v. Bauer et al., Mag. No.: 11-3536 (MF) (D.N.J. Apr. 6, 2011), \url{http://www.justice.gov/usao/nj/Press/files/pdffiles/2011/Bauer,GarrettandKluger,MatthewComplaint.pdf}.}

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.”\footnote{Complaint, SEC v. Ni, No 11 CV 0708 DMR, at ¶ 15 (N.D. Cal. Feb. 16, 2011) (emphasis added), \url{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, Lit. Rel. No. 21859 (Feb 16, 2011), \url{http://www.sec.gov/litigation/litreleases/2011/lr21859.htm}.} 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 information
regarding the pending acquisition of [the company whose securities they traded] was confidential, material and nonpublic.”

It may be unwarranted to argue that these pleadings reflect the view of some members of the Commission or its staff that proof of knowledge of materiality is a distinct element of the violation, but these are public utterances, on repeated occasions, including at least one especially noteworthy case (Kluger), that reflect a perspective on what the elements of the violation are. One would not expect the SEC to plead more than it believes it must prove.

More commonly, however, there is no allegation in the SEC’s 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.” 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


144 Amended Complaint, SEC v. Longoria, 11-CV-0753 (JSR), at ¶¶ 131-32 (S.D.N.Y. Feb. 8, 2011), http://www.sec.gov/litigation/complaints/2011/comp21844.pdf. 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).
information which they knew to be material nonpublic information.\textsuperscript{145} 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, 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.\textsuperscript{146} This necessitates an inquiry into what the defendant perceived, or should have perceived, the risk of misleading to be,\textsuperscript{147} albeit in cases where the materiality of the omitted information is patent 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.”\textsuperscript{148} 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.\textsuperscript{149}

The cases discussed in Part III 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

\textsuperscript{145} Amended Complaint, SEC v. Longoria, \textit{supra} note 144, at ¶¶ 141-42.

\textsuperscript{146} \textit{See supra} text accompanying notes 11-17, 28 and 73-76.

\textsuperscript{147} \textit{See, e.g., supra} text accompanying notes 101 and 107.

\textsuperscript{148} \textit{See supra} text accompanying notes 24-28.

\textsuperscript{149} \textit{See supra} text accompanying notes 17 and 73-76.
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.\textsuperscript{150}

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 – 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.\textsuperscript{151} When asked during the call if there 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 it 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. The plaintiff should not be able to establish liability under Rule 10b-5 because the executive made a good faith, i.e., non-reckless, judgment that the situation he did not disclose was not material – he did not intend to engage in any deception, much less “material” 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 of company. Again, the CEO, possibly with the benefit of advice of counsel,

\textsuperscript{150} See supra text accompanying notes 112-127 (addressing reliance on counsel) and 35-37 (discussing the mixed nature of the issue of materiality).

\textsuperscript{151} For this materiality test, see supra text accompanying note 38.
makes the judgment that the status of negotiations is not material, again applying the probability/magnitude assessment. Here, too, there has been no intent to deceive – the facts were, in the utmost good faith, thought to be immaterial – and it is not fair to say that the risk of misleading was “obvious.” At some point in the continuum of negotiations before the actual break down in discussions the deterioration of the relationship undoubtedly becomes material. The question is whether errors in that assessment before materiality is beyond doubt – even when in hindsight the facts were material when the CEO concluded in good faith that they were not – support a finding of recklessness.\textsuperscript{152} I argue that they do not.

It may be rare that an incomplete disclosure or trading based on a good faith (i.e., conscious) conclusion that a fact was not material is followed by a claim by a private plaintiff or the SEC that Rule 10b-5 was violated. There is another group of cases, also likely small in relative number, where the defendant may not even have given thought to the materiality of what he knew that was nonpublic; here, too, if the \textit{risk} of deception is not “obvious” because the facts were borderline material at most, then the defendant ought to be able to argue successfully his lack of scienter for failure to appreciate the materiality of what he knew. Even though this issue may emerge in a small minority of cases, it must nevertheless be recognized as a factor in the scienter analysis to exonerate those to whom the concept applies.

\textsuperscript{152} As commented earlier (\textit{supra} text accompanying note 79), it seems bizarre to say that someone “intended to deceive” when he did not believe that what he failed to say would have been important to investors, that he believed disclosure would not have “significantly altered the ‘total mix’ of information.” \textit{See supra} text accompanying note 33.