 Printed in U.S.A.
Vol. 117, No. 6

THE UNREASONABLENESS OF REASONABLE: RETHINKING THE REASONABLE INVESTOR STANDARD

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ABSTRACT—This Note explores the "reasonable investor" standard in light of recent developments in pandemic-era securities litigation. Scholars have long criticized the reasonable investor standard for determining materiality. Given the dramatic backdrop of the COVID-19 pandemic, the limitations of the standard are becoming ever more evident. This Note provides a brief history of the development of the current standard and highlights some of its problems through two recent COVID-19 securities fraud cases. This Note argues that the reasonable investor standard is no longer sufficient to protect investors. Through examining tort law and First Amendment jurisprudence, this Note differentiates between the "reasonable" and "average" persons and recommends replacing the reasonable investor standard with the average investor standard.

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INTRODUCTION

In December 2021, electric-vehicle start-up Nikola Corporation agreed to pay $125 million in penalties to settle securities fraud charges brought by the Securities and Exchange Commission (SEC).[1] In September 2021, Twitter settled an investor securities fraud class action for $809.5 million.[2] In September 2018, to settle securities fraud charges brought by the SEC, Elon Musk agreed to step down as Tesla's chairman and pay a $20 million penalty.[3] And over a decade ago, financial institutions that allegedly assisted Enron in securities fraud agreed to pay investors $7.2 billion to settle a class

[1] Press Release, SEC, Nikola Corporation to Pay $125 Million to Resolve Fraud Charges (Dec. 21, 2021), https://www.sec.gov/news/press-release/2021-267 [https://perma.cc/2E7W-WL9Z].

[2] Molly Schuetz & Robert Burnson, *Twitter Agrees to Pay $809.5 Million Settlement in Shareholder Class Action Lawsuit*, TIME (Sept. 20, 2021, 5:27 PM), https://time.com/6099976/twitter-class-action-lawsuit/ [https://perma.cc/2QBA-LRWQ].

[3] Press Release, SEC, Elon Musk Settles SEC Fraud Charges; Tesla Charged with and Resolves Securities Law Charge, (Sept. 29, 2018), https://www.sec.gov/news/press-release/2018-226 [https://perma.cc/QJH5-6LX9].

action lawsuit.[4] There is a crucial element that all of these high-profile, high-price-tag legal claims have in common: materiality.[5]

The concept of materiality appears repeatedly in the Securities Act of 1933 (the '33 Act) and the Securities Exchange Act of 1934 (the '34 Act), both of which were enacted after the Great Depression to protect investors and today remain the two most important pieces of securities legislation. Section 11(a) of the '33 Act imposes civil liability on a corporate actor when its registration statement contains an untrue statement of a *material* fact or an omission of a *material* fact required to be stated or necessary to make the statement not misleading.[6] Section 12(a)(2) of the '33 Act imposes liability for a misstatement or omission of a *material* fact contained within a prospectus or oral communication.[7] Section 17(a)(2) of the '33 Act makes it unlawful to obtain money or property through a misstatement or omission of a *material* fact.[8]

Section 14 of the '34 Act and SEC Rule 14a-9 promulgated thereunder make it unlawful to solicit a proxy by a communication that contains a false or misleading statement of a *material* fact or an omission of a *material* fact necessary to make the statement not false or misleading.[9] Section 14(e) of the '34 Act makes unlawful any untrue statement or omission of a *material* fact made in connection with a tender offer or invitation for a tender offer.[10] Section 18(a) of the '34 Act imposes liability on any person who makes a false or misleading statement or omission of a *material* fact in any filed application, report, document, or registration statement.[11] And SEC Rule 10b-5, promulgated under Section 10(b) of the '34 Act, makes it unlawful "[t]o make any untrue statement of a *material* fact or to omit . . . a *material* fact necessary in order to make the statements made . . . not misleading . . . in connection with the purchase or sale of any security."[12]

These statutory provisions provide a cause of action only when the underlying statement or omission is material. This raises the question: what is material? More than forty years ago, the Supreme Court established and

4 Karina Frayter, *Enron Investors to Split Billions from Lawsuit*, CNN (Sept. 9, 2008, 9:12 PM), http://www.cnn.com/2008/US/09/09/enron.settlement/ [https://perma.cc/V8GM-YGN7].

5 *See* Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "the Reasonable Investor" with "the Least Sophisticated Investor" in Inefficient Markets*, 81 TUL. L. REV. 473, 475 (2006).

6 15 U.S.C. § 77k(a).

7 *Id.* § 77l(a)(2).

8 *Id.* § 77q(a).

9 *Id.* § 78n; 17 C.F.R. § 240 14a-9 (2020).

10 15 U.S.C. § 78n(e).

11 *Id.* § 78r(a).

12 17 C.F.R. § 240.10b-5 (2006) (emphases added); *see* 15 U.S.C. § 78j(b).

refined the current "reasonable person" standard for determining materiality in *TSC Industries v. Northway, Inc.* and *Basic Inc. v. Levinson*.[13] This standard is still the topic of much academic debate. Given the COVID-19 pandemic's impact on market unpredictability, this is as pressing a topic as ever.

This Note joins the legal discourse on the current standard and possible reforms for determining materiality in securities law.[14] Specifically, this Note joins other scholarship in examining the inadequacies of the reasonable investor standard by analyzing recent developments in securities litigation during the COVID-19 pandemic. It goes beyond the current legal scholarship to recommend implementing an "average investor" standard.[15] Supplementing this recommendation, it finds the dichotomy between the "reasonable person" and "average person," which the Supreme Court has recognized in First Amendment jurisprudence, to be similarly applicable to securities regulation.

Part I of this Note discusses the development of the current standard and the policy considerations behind it. Part II examines two contradictory judicial opinions issued during COVID-19 and the issues with the current materiality standard they highlight. Part III explores the reasonable person standard from tort law and the *Miller* test from First Amendment jurisprudence to suggest a standard centering on the "average investor." Finally, Part IV recommends that the reasonable person standard be replaced with the average investor standard and considers the benefits such a change might bring.

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[13] *See infra* Section I.A; TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976); Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

[14] *See, e.g.*, Barbara Black, *Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets*, 44 LOY. U. CHI. L.J. 1493, 1493 (2013) (arguing that the gap between the judicial view of a reasonable investor and behavioral economists' view of an investor's cognitive shortcomings hinders the ability of federal securities regulations to protect investors from fraud); Sachs, *supra* note 5, at 479–80 (pointing out the inadequacies of the current standard in protecting underclass investors); Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. REV. 461, 476–77 (2015) (noting a dissonance between "the homogeneity of the reasonable investor paradigm and the heterogeneity of [actual] investors" that limits the effectiveness of financial regulation); Amanda M. Rose, *The "Reasonable Investor" of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. CORP. L. 77, 83–86 (2017) (comparing tort law and securities law to highlight the unworkability of the reasonable investor standard).

[15] The "average investor" can encompass a wide variety of investor profiles. See Professor Tom C.W. Lin's article, *Reasonable Investor(s)*, for a discussion of the typology of investors. Lin, *supra* note 14, at 466–76. Specifically, this Note bases its conception of the average individual investor on Professor Lin's "ordinary irrational investor." *Id.* at 468–71.

I. THE *NORTHWAY–BASIC* STANDARD

This Part provides a brief history of the development of the reasonable investor standard to illustrate some of the considerations behind implementing an objective standard. Despite the standard's thirty-year history, it is still not abundantly clear who the reasonable investor is. However, this Part outlines some of the key characteristics that are widely attributed to the reasonable investor.

A. The Development of the Reasonable Investor Standard

Despite materiality's evident importance in establishing securities violations, neither the '33 and '34 Acts nor the rules promulgated thereunder define materiality.[16] Instead, the current standard for materiality stems from judicial decisions, specifically *TSC Industries v. Northway, Inc.*, and *Basic Inc. v. Levinson*.[17]

In the early days after the '33 and '34 Acts' adoption, the materiality standard was considerably low, affording protection to relatively uninformed investors. In 1942, one court noted that "[i]t may be that the averred scheme would not have deceived a person of ordinary intelligence" when holding that a statement that was wholly implausible was still material.[18] The court's formulation here was notable for suggesting that a statement was material even if it managed to mislead only those with less-than-ordinary intelligence.

In a marked shift, this standard was elevated in 1976, when the Supreme Court held in *Northway* that, under Section 14(a) of the '34 Act and Rule 14a-9:

> An omitted fact is material if there is a substantial likelihood that a *reasonable* shareholder would consider it important in deciding how to vote. . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would

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16 *See* Sachs, *supra* note 5, at 475.

17 *Northway*, 426 U.S. at 449; *Basic*, 485 U.S. at 240.

18 United States v. Monjar, 47 F. Supp. 421, 425 (D. Del. 1942), *aff'd*, 147 F.2d 916 (3d Cir. 1944). The defendant managed to solicit loans that he stated he needed as living expenses and in return guaranteed the lenders' financial independence. *Id.* at 423–24. The defendant was criminally indicted for violating Section 17 of the '33 Act. *Id.* at 427. The court found it difficult to believe that the victims could have accepted and acted upon the alleged statements, yet still found that violation of Section 17 was sufficiently alleged. *Id.* at 425. Note that this is securities litigation at its most primitive stage. The court merely focused on whether there was a scheme to defraud in the sale of securities. *See id.* at 427. And even "fantastic" statements that require courts to imagine the "unmeasured" "credulity of mankind" are deemed actionable. *See id.* at 425 (quoting O'Hara v. United States, 129 F. 551, 555 (6th Cir. 1904)); Sachs, *supra* note 5, at 483–84.

have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[19]

The Court reasoned that an unnecessarily low standard of materiality might result in management burying shareholders in "an avalanche of trivial information" out of fear of exposure to substantial liability.[20] Twelve years later in *Basic*, the Court explicitly adopted the *Northway* standard in the context of Rule 10b-5.[21] Later, the SEC adopted a similar standard in Rule 405.[22]

This elevated standard is consequential in several ways. First, it crystallized that materiality is an *objective* matter rather than a subjective one.[23] Thus, the Court clarified that materiality does not examine whether any particular information would be material to any particular investor. This doctrinal shift converted materiality into a common issue for all investors who may have been defrauded. As a result, investors could bring fraud claims under Rule 10b-5 *as a class*.[24] Second, it emphasized that materiality is a contextual determination—rather than focusing on a discrete piece of information, courts must discern whether a material misrepresentation "significantly altered the 'total mix' of information."[25] Lastly, it considerably raised the bar for materiality, as compared to *Monjar*.[26] For instance, it is no longer sufficient to establish materiality by showing a statement would have misled some investors who do not grasp market fundamentals.

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19 426 U.S. at 449 (emphasis added). In this case, following National Industries, Inc.'s acquisition of TSC Industries, Inc. stocks, Northway (a TSC shareholder) sued TSC and National, alleging that they violated Section 14(a) of the '34 Act and Rules 14a-3 and 14a-9 (proxy solicitation) by not disclosing National's resulting control of TSC and the favorability of the proposal's terms to TSC shareholders in their joint-proxy statement. *Id.* at 440–43.

20 *Id.* at 448.

21 *Basic*, 485 U.S. at 232. In *Basic*, Basic Inc. was in possible merger discussions, but denied it was engaged in merger negotiations in three public statements. Investors allegedly relied on those statements and sold their stock at low prices. *Id.* at 226–28. The Court "expressly adopt[ed] the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context." *Id.* at 232. Section 10(b) and Rule 10b-5 regulate securities transactions in the secondary market. *See* 17 C.F.R. § 240.10b-5 (2006); 15 U.S.C. § 78j(b).

22 *See* 17 C.F.R. § 230.405. Rule 405 lists definitions of all terms used in §§ 230.400–.494 of the SEC regulation. It specifically adopted the *Northway–Basic* standard as the definition of "material."

23 Sachs, *supra* note 5, at 488.

24 To bring a securities class action seeking monetary damages, a class must satisfy the requirements outlined in Federal Rules of Civil Procedure Rules 23(a) and 23(b)(3)—namely numerosity, commonality, adequacy, typicality, predominance, and superiority. FED. R. CIV. P. 23(a), (b)(3). Commonality, specifically, requires that members of the class share a common question of law or fact. *Id.* R. 23(a)(2). If materiality is an individualized, or subjective, determination, the commonality requirement cannot be met, and class action would be virtually impossible. *See* Amgen v. Conn. Ret. Plans & Tr. Funds, 568 U.S. 455, 467 (2013).

25 *Northway*, 426 U.S. at 449.

26 Sachs, *supra* note 5, at 485.

Perhaps equally as consequential to the development of securities litigation was what the Court left unsaid: it failed to define key phrases such as "substantial likelihood" or "significantly altering." More importantly, the Court never made clear who the reasonable investor is. With materiality structured around this "person's" perspective, many have tried to determine who the reasonable investor is. With securities class actions constituting nearly half of all class actions filed in federal court in recent years, a lot rides on this answer.[27]

B. The Reasonable Investor

At the expense of countless litigants, there has yet to be unanimous agreement as to the identity of the "reasonable investor," leaving the figure "at best fluid and at worst ill-defined."[28] There are, however, a few characteristics that regulators, courts, practitioners, and scholars widely attribute to the reasonable investor. Case law developed over the thirty-some years after *Basic* has led scholars to conclude that the reasonable investor is a rational actor who possesses some knowledge of business and finance.[29]

First, there is a patchwork of case law getting at the intellect of the investor. The bits of guidance from the Supreme Court reflect that the reasonable investor is not a "nitwit" with "child-like simplicity."[30] Lower courts further paint a picture of the reasonable investor as someone with some knowledge of finance. As such, the reasonable investor should realize "that relying on assumptions is dangerous."[31] They acknowledge there are possible problems and delays involved in any new business venture.[32] They

[27] John C. Coffee Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006) (describing securities class actions as the "800-pound gorilla that dominates and overshadows other forms of class actions").

[28] Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 293 (2009); *see also* Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 344 (2008) ("There are differing notions as to who exactly this reasonable investor is for purposes of materiality determinations under the securities laws. . . . However, courts have not spoken in one voice on this point . . . .").

[29] *See, e.g.*, Lin, *supra* note 14, at 466–67 (observing that the "leading paradigm" views the reasonable investor as "the idealized, perfectly rational actor of neoclassical economics"); David A. Hoffman, *The "Duty" To Be a Rational Shareholder*, 90 MINN. L. REV. 537, 542 (2006) ("[C]ourts implicitly equate investors' 'reasonableness' with economic rationality."); Heminway, *supra* note 28, at 297 ("Decisional law . . . support[s] the view that the reasonable investor is a rational investor . . . ."); Black, *supra* note 14, at 1495 (noting that "courts hold investors to a high standard of rationality").

[30] Basic Inc. v. Levinson, 485 U.S. 224, 234 (1988) (quoting Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987)).

[31] Harris v. Ivax Corp., 182 F.3d 799, 807 (11th Cir. 1999).

[32] Hillson Partners v. Adage, Inc., 42 F.3d 204, 213 (4th Cir. 1994).

understand the time value of money.[33] At the same time, the reasonable investor is not expected to possess the savviness of trained professionals.[34]

Another distinct characteristic of the reasonable investor is *rationality*. The reasonable investor is "the idealized, perfectly rational actor of neoclassical economics,"[35] the *homo economicus* that aims to maximize wealth or utility.[36] In fact, after examining relevant case law, Professor David Hoffman went as far as to conclude that the current reasonable investor standard of materiality is "a proxy for economic rationality."[37] It is this characteristic that draws the most criticism to the *Northway–Basic* standard. Commentators question whether the reasonable investor is representative of real investors in the market,[38] and if not, whether securities law is serving its purpose of investor protection.[39] Indeed, neoclassical economics's assumption of economic rationality itself has been challenged on many fronts, and an entire field of economics—known as behavioral economics[40]—has developed to address these questions.[41] At a minimum, this suggests that equating the reasonable investor standard readily with the notion of *homo economicus* is not entirely innocuous.

To be sure, the *Northway–Basic* reasonable investor standard does offer some benefits. For one, it is consistent with traditional economic theory and inherits the assumption that all economic actors are perfectly rational, built into many models. It, therefore, grants courts and litigants the freedom to use any classic economic model to explain market behavior. For another, by rendering an objective standard, it facilitates class actions. Under Federal Rule of Civil Procedure 23, an action must fulfill numerosity, commonality, typicality and adequacy to qualify for class treatment.[42] If each shareholder

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33 Levitin v. PaineWebber, Inc., 159 F.3d 698, 702 (2d Cir. 1998).

34 *See* Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991) (observing that a mixture of truth will not neutralize deception "[i]f it would take a financial analyst to spot the tension between the one and the other").

35 Lin, *supra* note 14, at 467.

36 *Homo Economicus*, BEHAV. ECON., https://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/homo-economicus/ [https://perma.cc/SRV3-4S39].

37 *See* Hoffman, *supra* note 29, at 604.

38 *See, e.g.*, Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 2 (2003) (noting that not all investors are rational and that unsophisticated and sophisticated investors alike suffer from biases that are "consistent, deep-rooted, and systematic behavioral patterns"); Lin, *supra* note 14, at 468–69 (noting that "the perfect rationality of the reasonable investor . . . is rooted more in theory than in fact").

39 *See, e.g.*, Sachs, *supra* note 5, at 476 (arguing that the *Northway–Basic* standard cannot "address the fraud that deceives certain unsophisticated investors").

40 *See infra* note 99 and accompanying text.

41 *See* Choi & Pritchard, *supra* note 38, at 2–3; Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1473 (1998).

42 FED. R. CIV. P. 23(a).

is required to prove that a statement is subjectively material to him, the "commonality" requirement cannot be met and class action is not possible. Given the relative power imbalance between individual shareholders and companies, particularly with litigation costs, the inability to bring a class action will leave many shareholders unable to seek a legal remedy. Further, as explained above, raising the materiality standard prevents both frivolous litigation and companies dumping trivialities on investors. Nevertheless, it is unclear whether the benefits of this formulation outweigh its costs.

II. AN INCONSISTENT STANDARD

This Part discusses recent developments in securities litigation during the COVID-19 pandemic to illustrate key drawbacks of the current reasonable investor standard. In June 2020, when most of the relevant facts occurred in the cases discussed below, the country was in quarantine, and the world was desperate for a vaccine.[43] Around this time, the government announced Operation Warp Speed, a federal effort to speed up COVID-19 vaccine development through government assistance.[44] Known recipients at the time included Pfizer and Moderna, both of which eventually succeeded in developing and mass-producing a vaccine on similar timelines.[45] Under any circumstances, pharmaceutical development is costly and can be very risky.[46] Confirmed receipt of reliable government funding, particularly on a pandemic's rushed timeline, was a sign of the government's confidence in a company's capabilities and was essential to boosting investor confidence.

The messaging surrounding this funding was the perfect storm for securities fraud litigation. A mere hint that a company was going to receive

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[43] *See, e.g.*, Harvey V. Fineberg & Shirley M. Tilghman, *How to Counter Vaccine Skepticism if a Coronavirus Vaccine Becomes Available*, FORTUNE (June 9, 2020), https://www.fortune.com/2020/06/09/coronavirus-vaccine-misinformation-hesitancy-skepticism/ [https://perma.cc/SR7F-7ZYY] (discussing the "desperate search for a vaccine against the novel coronavirus").

[44] U.S. GOV'T ACCOUNTABILITY OFF., GAO-21-319, OPERATION WARP SPEED: ACCELERATED COVID-19 VACCINE DEVELOPMENT STATUS AND EFFORTS TO ADDRESS MANUFACTURING CHALLENGES, at i (2021), https://www.gao.gov/assets/gao-21-319.pdf [https://perma.cc/8LSJ-8TT3].

[45] *Was the Pfizer Vaccine Part of the Government's Operation Warp Speed?*, N.Y. TIMES (Nov. 10, 2020), https://www.nytimes.com/2020/11/10/health/was-the-pfizer-vaccine-part-of-the-governments-operation-warp-speed.html [https://perma.cc/6GKS-SGYL]; Carl Zimmer, *Is Moderna in Operation Warp Speed?*, N.Y. TIMES (Nov. 16, 2020), https://www.nytimes.com/2020/11/16/health/operation-warp-speed.html [https://perma.cc/WQZ9-AS65]; *Comparative Effectiveness of Moderna, Pfizer-BioNTech, and Janssen (Johnson & Johnson) Vaccines in Preventing COVID-19 Hospitalizations Among Adults Without Immunocompromising Conditions — United States, March–August 2021*, CDC (Sept. 24, 2021), https://www.cdc.gov/mmwr/volumes/70/wr/mm7038e1.htm [https://perma.cc/75RF-K684].

[46] *See Research and Development in the Pharmaceutical Industry*, CONG. BUDGET OFF. (Apr. 2021) https://www.cbo.gov/publication/57126 [https://perma.cc/QQ6E-SHDW] (describing how pharmaceutical development is "a costly and uncertain process, and many potential drugs never make it to market").

Operation Warp Speed funding would suggest that the company was in the same league as Pfizer and Moderna, and could drastically affect that company's stock price, as the market was sensitive to related information. At the time, a vaccine company did not have to do much to generate investor interest, making market manipulation particularly easy.[47] Set against this unprecedented background, the two cases discussed in this Part are particularly revealing illustrations of the drawbacks of the current reasonable investor standard. These two cases were selected because they involve similar fact patterns, yet two courts came to the opposite conclusion regarding materiality.[48]

A. McDermid v. Inovio Pharmaceuticals, Inc.

In *McDermid v. Inovio Pharmaceuticals*, shareholders filed suit in the Eastern District of Pennsylvania alleging that Inovio Pharmaceuticals and its officers made false or misleading statements about the company's COVID-19 vaccine in violation of Section 10(b) of the '34 Act and Rule 10b-5.[49]

Inovio is a "biotechnology company focused on bringing to market DNA medicines."[50] It has over two hundred employees, and its market capitalization exceeds $400 million.[51] In 2020, the company made efforts to develop a COVID-19 vaccine candidate: INO-4800.[52] On June 30, 2020, Inovio issued a press release announcing "INO-4800 Selected for the U.S. Government's Operation Warp Speed."[53] Critically, however, Inovio's INO-4800 was selected only for a preliminary study *and was not eligible to receive federal funding*.[54] Buried within the full press release was a short clarification that the company's vaccine was only selected "to participate in a non-human primate (NHP) challenge study as part of the U.S.

[47] Trefis Team, *Down 40% from Recent Highs Can Inovio Pharmaceuticals Stock Rebound?*, FORBES (Mar. 24, 2021, 7:30 AM), https://www.forbes.com/sites/greatspeculations/2021/03/24/down-40-from-recent-highs-can-inovio-pharmaceuticals-stock-rebound/?sh=6ab4a7c65655 [https://perma.cc/GJM9-37A4].

[48] The two courts are the Eastern District of Pennsylvania and Northern District of California. The differences in the decisions might stem from one court being more plaintiff-friendly than the other. This Note will not explore this issue.

[49] 520 F. Supp. 3d 652, 657, 660 (E.D. Pa. 2021).

[50] *Id.* at 657.

[51] *Inovio Pharmaceuticals Number of Employees 2010–2022 | INO*, MACROTRENDS, https://www.macrotrends.net/stocks/charts/INO/inovio-pharmaceuticals/number-of-employees [https://perma.cc/ZC3N-QZRQ]; *Inovio Pharmaceuticals Market Cap 2010–2022 | INO*, MACROTRENDS, https://www.macrotrends.net/stocks/charts/INO/inovio-pharmaceuticals/market-cap [https://perma.cc/N6JW-KLB7].

[52] *McDermid*, 520 F. Supp. 3d at 657.

[53] *Id.* at 659.

[54] *See id.* at 660, 669.

government's Operation Warp Speed."[55] Shareholders contended that the announcement, which was the first sentence of the press release, misled investors to believe that Inovio "had been chosen to receive government funding."[56] Shareholders alleged they suffered significant losses when the truth about these statements came to public light.[57]

Specifically, shareholders claimed that Inovio made false and misleading statements regarding its vaccine that artificially inflated the company's stock price.[58] Shareholders supported their claim through "data showing increases in Inovio's stock price around the time of each alleged false or misleading statement."[59] The district court, ruling on Inovio's motion to dismiss, found that shareholders sufficiently met the pleading standards for two of the three claims.[60] Importantly, however, the court dismissed one of the claims on the basis that the contested statements were not material: specifically, the court applied the reasonable investor standard to hold that the defendant's statements were neither material nor misleading, as they disclosed the selection for the NHP study in the same document.[61]

Receiving government funding in support of research and development can be a financial windfall and significant confidence booster for a pharmaceutical company, and is undoubtedly information that could sway investment decisions. Having a reliable source of funding can mean the difference between success and failure, regardless of any merit to the underlying project. Had Inovio secured government funding, the general public could have interpreted this as a signaling effect regarding the potential held by Inovio's vaccine candidate. In reality, Inovio never claimed it would receive government funding. The press release emphasized that its vaccine

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55 *See id.* at 669.

56 *See* Press Release, Inovio, INOVIO Announces Positive Interim Phase 1 Data for INO-4800 Vaccine for COVID-19 (June 30, 2020), https://s23.q4cdn.com/479936946/files/doc_news/INOVIO-Announces-Positive-Interim-Phase-1-Data-For-INO-4800-Vaccine-for-COVID-19-2020.pdf [https://perma.cc/2GPF-4YNA]; *McDermid*, 520 F. Supp. 3d at 669. A chart showing stock-price movement during the class period was provided in Plaintiff's amended complaint. Based on this chart, there isn't a noticeable increase in stock price around June 30, 2020, the date of this announcement. *See* First Amended Consolidated Class Action Complaint, McDermid v. Inovio Pharms., Inc., No. 2:20-cv-01402-GJP (E.D. Pa. Sept. 21, 2020), https://storage.courtlistener.com/recap/gov.uscourts.paed.568965/gov.uscourts.paed.568965.68.0.pdf [https://perma.cc/RPS4-HVSE].

57 *McDermid*, 520 F. Supp. 3d at 660.

58 *Id.* at 658–59.

59 *Id.* at 660.

60 *Id.* at 662. Shareholders brought three claims of securities fraud. The first concerns Inovio CEO's public statements that the company had constructed a vaccine when it had merely designed one. *Id.* The second is regarding Inovio's statements about its production capabilities. *Id.* at 665. The court found that, except for one press release, Inovio's public statements on this issue were problematic. *Id.* at 667. The last claim related to Operation Warp Speed. *Id.* at 668. This Note focuses only on the last claim.

61 *Id.* at 669.

was chosen for a preliminary study in the government program.[62] The court found that the shareholders did not explain how or why reasonable investors with access to the full press release would have thought Inovio would receive government vaccine funding. Therefore, the court did not determine that the announcement constituted a misrepresentation. The court then reasoned that even if the initial announcement was in and of itself a misrepresentation, the subsequent disclosure contained within the press release regarding the extent of Inovio's participation in Operation Warp Speed altered the total mix of information and rendered it immaterial.

Underlying the *Inovio* decision are some assumptions about the reasonable investor. First, it assumes that the reasonable investor would appreciate the difference between being selected as a vaccine candidate for Operation Warp Speed and merely participating in an NHP study. In addition, it assumes that the reasonable investor would read through and process a six-page, two-thousand-word press release amidst much pandemic and vaccine-related news in June 2020. And upon reading the press release, the reasonable investor would be able to understand the single-sentence statement regarding the company's limited participation in Operation Warp Speed. Though one might question if the majority of investors in June 2020 were truly capable of all that was described above, the Eastern District of Pennsylvania paints a picture of the reasonable investor as an individual who is rational, meticulous, and somewhat knowledgeable. This is largely in line with scholarly work and existing case law.[63]

B. In re Vaxart, Inc. Securities Litigation

When presented with similar facts, the Northern District of California reached the opposite conclusion. In *In re Vaxart, Inc. Securities Litigation*, shareholders alleged that Vaxart, Inc., a vaccine development company, and its officers violated Section 10(b) and Rule 10b-5 by issuing a series of materially misleading press releases.[64] One press release from June 26, 2020 included a headline claiming Vaxart's COVID-19 vaccine was "selected" for Operation Warp Speed.[65] The fact pattern could not be more similar to that of *Inovio*. Like Inovio, Vaxart was merely selected to participate in a preliminary study and was not eligible to receive government funding.[66] And like Inovio, Vaxart clarified in a smaller font in its press release that it had

62 *Id.*

63 *See, e.g.*, Lin, *supra* note 14, at 467 (conceptualizing the reasonable investor to be "the idealized, perfectly rational actor of neoclassical economics").

64 576 F. Supp. 3d 663, 666 (N.D. Cal. 2021).

65 *Id.* at 668.

66 *See id.* at 668, 672.

"been selected to participate in a non-human primate (NHP) challenge study, organized and funded by Operation Warp Speed."[67] Immediately following the announcement, Vaxart stock peaked at $14.30, eventually closing at $8.04, up 28% from the day before.[68]

Vaxart argued that the press release was the literal truth and thus could not be misleading.[69] It referenced the earlier *Inovio* decision, emphasizing the facts in the two cases were essentially identical.[70] However, relying on Ninth Circuit precedent from *Miller v. Thane International, Inc.*, the *Vaxart* court reasoned that literal truths can mislead a reasonable investor "when considered in context."[71]

In the context of this case, the federal government's May 2020 announcement of Operation Warp Speed sparked speculation about which pharmaceutical companies might be chosen to receive taxpayer funds.[72] By early June, only five recipients were identified, although it was known that as many as eight companies could be selected.[73] The court found that "the trickle of information about Warp Speed prompted investors to perch at the edge of their seats, eager to find the next rocket stock."[74] The court determined that in this context, Vaxart's "manner of presentation," namely the difference in font size between the headline and the explanation in the body, as well as the timing of the announcement, exploited a gap in public knowledge and created a misleading impression that the company was about to receive government funding.[75] The court stated that only sophisticated investors, not reasonable investors, "might have been able to avoid being fooled by the company's series of head-fakes."[76]

C. Which Court Got It Right?

How should one make sense of these inconsistent holdings? Given the factual similarities between the two cases, this split hinges on the proper application of the *Northway–Basic* reasonable investor standard. The *Vaxart* court injected an "anticipation" consideration into the analysis—when the market is waiting for a certain piece of information with bated breath,

67 *Id.*
68 *Id.* at 668.
69 *Id.* at 671.
70 *Id.* at 672.
71 *Id.* at 671–72 (quoting Miller v. Thane Int'l, Inc., 519 F.3d 879, 886 (9th Cir. 2008)).
72 *Id.* at 667.
73 *Id.*
74 *Id.* at 672.
75 *Id.* at 671–72.
76 *Id.* at 667.

reasonable investors cannot be expected to read past the headline of a press release, nor can they comprehend nuances around the statement that the company has been selected to participate in the NHP study of Operation Warp Speed.[77] Even if sensible, this reasonable investor standard is decidedly different from the rational dispassionate investor most scholars envision and the *Inovio* court followed. Therefore, the *Inovio* court's application of the *Northway–Basic* standard as it is currently framed is likely more proper.

Looking more closely, the *Vaxart* court arrived at its decision by raising the issue of "full context." Indeed, the Supreme Court has stressed that materiality is a "fact-specific inquiry."[78] The Supreme Court refined this analysis in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, explaining that a reasonable investor would need to consider a statement in "full context," which includes the "customs and practices of the relevant industr[ies]" and the "surrounding text, including hedges, disclaimers, and apparently conflicting information."[79] With *Omnicare* in mind, *Inovio* again seems to be the correct decision under current precedent. The press releases by Vaxart and Inovio are not misleading, given the surrounding text, which indicates the companies are involved in the preliminary study. There was no mention of government funding. There was no reporting by news sources that either company was going to receive government funding.[80] Under this context, a well-informed reasonable investor is unlikely to be misled.

Under the guise of "full context," the *Vaxart* court focused on a different set of contextual factors, such as abnormal market hype and investor emotions, to reach its conclusion.[81] However, to most commentators, the ability to "read[] and comprehend[] all the noise and signals in the marketplace that encapsulate formal disclosures, economic data, market trends, senseless speculation, and irresponsible rumors"[82] is central to the concept of the reasonable investor. Given that the reasonable

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[77] Interestingly, the Ninth Circuit was once one of the most corporate-friendly forums. *See* Patrick Hall, *The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit's Interpretation of Materiality in* Employer-Teamster v. America West, 2004 BYU L. REV. 863, 864 (2004). However, it appears that the circuit is changing course post-Enron, due to "the shift in the political and economic landscape." *Id.*; *see also Vaxart*, 576 F. Supp. 3d at 671–72.

[78] Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 43 (2011) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988)).

[79] 575 U.S. 175, 190 (2015). *Omnicare* confirmed that under Section 11 of the '33 Act, omissions should be judged under the *Northway–Basic* standard as well. *Id.* at 187.

[80] The *Vaxart* court noted that the known recipients of government funding were identified by the press, which arguably could be seen as industry practice. 576 F. Supp. 3d at 667.

[81] *Id.* at 671–72.

[82] Lin, *supra* note 14, at 467.

investor is a rational being, the *Vaxart* court's consideration of these factors is inappropriate. A reasonable investor, who is rational at all times, should not be affected by market hype. Even if the market is in breathless anticipation of certain news, the reasonable investor would not participate in the anticipation. Furthermore, the reasonable investor would be able to factor in abnormal market conditions when assessing any market reaction. The factors considered by the *Vaxart* court, theoretically, do not affect the reasonable investor because they either constitute market noise—something to be discounted—or are a sign of irrationality.

Note, the court found that scienter was sufficiently pled in *Vaxart*.[83] As the court stated, it is "unusual" for a case to "easily satisf[y]" the heightened pleading standards for scienter yet struggle with pleading with materiality.[84] However, here, the court found that scienter, or an intent to deceive, was easily determinable.[85] In addition, there is evidence of a strong market reaction to Vaxart's announcement, suggesting that investors were affected by the company's statements.[86] However, under the reasonable investor standard, shareholders do not have a cause of action unless a court misapplies the standard for materiality, even when a company possibly had the intent to deceive and potentially succeeded in deception.[87] Given that securities regulation was enacted to protect investors, a correct application of the reasonable investor standard which leaves investors unprotected makes one question the propriety of the current standard.[88]

D. Problems with the Current Standard

The *Inovio* and *Vaxart* decisions demonstrate the biggest issues with the *Northway–Basic* standard. Because the standard's focus is an elusive figure, courts are afforded too much discretion, which leads to unpredictability for both companies and investors. More importantly, as mounting evidence increasingly disproves the existence of the somewhat-learned-but-perfectly-rational investor, the standard is failing to protect actual investors in the market.

[83] 576 F. Supp. 3d at 666.

[84] *Id.* For a discussion of scienter, see *infra* notes 163–164 and accompanying text.

[85] *Vaxart*, 576 F. Supp. 3d at 666.

[86] *Id.* at 668.

[87] *See* Rose, *supra* note 14, at 86.

[88] *See, e.g.*, SEC, PERFORMANCE AND ACCOUNTABILITY REPORT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION 5 (2004), https://www.sec.gov/about/secpar/secparsumm04.pdf [https://perma.cc/XD7M-ENZJ].

1. *Unpredictability and Forum Shopping*

When faced with almost the same set of facts, two district courts, in the span of a few months, came out with opposite conclusions because they did not agree on who the reasonable investor was. In the Eastern District of Pennsylvania, a reasonable investor could not have been misled after reviewing Inovio's press release, whereas in the Northern District of California, a reasonable investor would have fallen prey to the "head-fake" of essentially the same press release.

The premier purpose of federal securities legislation such as the '33 and '34 Acts is to afford investors across the country the same protection under these laws.[89] Materiality, in theory, should not be a jurisdiction-dependent determination. What is material in Pennsylvania must be material in California and vice versa. A doctrinal split of this nature will turn securities litigation from a merits-based quest to a lawyers' game.[90] Section 27 of the '34 Act grants federal courts exclusive jurisdiction and provides that any suit or action brought under the Acts can be brought in any district wherein "the defendant is found or is an inhabitant or transacts business."[91] Considering that most companies subject to the governance of the '34 Act likely transact business in many states, this is a very liberal venue provision that allows plaintiffs a wide selection of possible forums in which to sue. Even more liberal is Section 22 of the '33 Act, which grants jurisdiction to both federal and state courts and allows any suit or action to proceed in any district—including the district where the offer or sale took place.[92]

In this modern age, the offer and sale of securities for almost all companies likely happen in all states. Further exacerbating this situation, the Supreme Court ruled unanimously in *Cyan, Inc. v. Beaver County Employees Retirement Fund* that, even after reform, class actions under the '33 Act can be brought in state court and are not removable to federal court.[93] This decision opens the doors of state court to '33 Act litigants. Some are concerned that the case is a "catalyst for class-action-litigation lawyers to search for the most-plaintiff-friendly jurisdiction and thus introduce all the well-recognized perils associated with forum-shopping and inconsistent,

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[89] *Id.*

[90] *See* Van Dusen v. Barrack, 376 U.S. 612, 636 n.34 (1964) (noting that a possible difference in law could lead to forum shopping or "a game of chess").

[91] 15 U.S.C. § 77v(a).

[92] *Id.*

[93] 138 S. Ct. 1061, 1078 (2018).

unpredictable standards across multiple jurisdictions."[94] Already in the past decade, plaintiffs' lawyers have shown a preference for California state court for '33 Act class actions.[95] This is not to say an even more plaintiff-friendly state court will not emerge.

Unfortunately, the large degree of discretion given to courts is also unavoidable. Because there is little guidance, let alone consensus, on who reasonable investors are and how they behave, investors and companies must rely on the unpredictable imaginations of the sitting judge in their jurisdiction to determine their fate. Given the fact-specific nature of any materiality determination, an ex ante, bright-line rule is likely to be either underinclusive or overinclusive. While the common law is littered with ambiguous standards, this one is made worse by the reasonable investor possessing a quality few humans possess: perfect rationality. Tasked with channeling a figure that exists only within classic economic theory, judges and juries are more likely to come to different conclusions about this hypothetical person's potential actions.

2. Lack of Investor Protection and the Duty to Act "Reasonably"

The reasonable investor is at the center of materiality determinations, and given current application, might impose a heightened duty on investors in the real world. Without a showing of action consistent with that of a reasonable investor, plaintiffs could be left without a cause of action. Therefore, to preserve the possibility for a legal remedy, investors must, at all times and in all circumstances, act as a reasonable investor would. Thus, securities law, as it stands, can be seen as almost imposing a "duty" upon investors to act reasonably.[96] Otherwise, they risk losing the protection of the many provisions of securities law that include materiality as an element.[97] Under this duty, they must be both rational and knowledgeable.[98] However, the blossoming field of behavioral economics in the investing context demonstrates that this standard is idealized and incongruent with human behavior.

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[94] Michael S. Flynn, Paul S. Mishkin & Edmund Polubinski III, *The Supreme Court's* Cyan *Decision and What Happens Next*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 3, 2018), https://corpgov.law.harvard.edu/2018/05/03/the-supreme-courts-cyan-decision-and-what-happens-next/#2 [https://perma.cc/H4X6-GGWX].

[95] *Id.*

[96] Hoffman, *supra* note 29, at 538.

[97] *Id.*

[98] *Id.* ("Courts require investors to investigate their purchases . . . and in general to be *economically rational*.").

One of the most important developments in the field of economics over the past several decades is the study of behavioral economics.[99] Neoclassical economics assumes that humans act with the single purpose of maximizing utility and that most individuals have "well-defined preferences and make well-informed, self-interested decisions."[100] So birthed the concept of *homo economicus*, the economic man who is capable of making rational and optimal decisions.[101] Behavioral economics, through combining psychological experiments and economics, has significantly undermined this assumption.[102] Behavioral economics looks at people as they are, a mix of "emotion and impulsivity . . . influenced by their environments and circumstances."[103]

Specific to this notion of the reasonable investor is that of the *rational* investor. Applying behavioral economics to the securities market, scholars have noted that investors are affected by a range of biases in their decision-making. They often are overconfident in their investment abilities,[104] prove unable to correctly assess probability,[105] suffer cognitive bias,[106] and let things as inconsequential as weather conditions affect their investing decisions.[107] Investors also struggle with loss aversion[108] and framing effects.[109] All of these "defects" suggest that how actual investors,

99 In 2017, Professor Richard H. Thaler, a leading scholar in the field of behavioral economics, won a Nobel Prize in Economics. His work explores the effect of *human* traits such as "*limited rationality*, *social preferences*, and *lack of self-control*" on individual decision-making. Press Release, Royal Swedish Acad. of Scis., The Prize in Economic Sciences 2017 (Oct. 9, 2017), https://www.nobelprize.org/prizes/economic-sciences/2017/press-release/ [https://perma.cc/M7KC-BS3V].

100 Max Witynski, *Behavioral Economics, Explained*, UCHICAGO NEWS, https://news.uchicago.edu/explainer/what-is-behavioral-economics [https://perma.cc/95MV-LH35].

101 *See* Steven D. Levitt & John A. List, *Homo Economicus Evolves*, 319 SCIENCE 909, 909 (2008), https://pricetheory.uchicago.edu/levitt/Papers/homo.pdf [https://perma.cc/4BGF-4QCW].

102 David A. Hoffman & Michael P. O'Shea, *Can Law and Economics Be Both Practical and Principled?*, 53 ALA. L. REV. 335, 360–63 (2002) (describing how behavioral studies undermined classical law and economics research); *see also* Witynski, *supra* note 100.

103 Witynski, *supra* note 100.

104 *See* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1459–61 (2002).

105 *See* David Hirshleifer, *Investor Psychology and Asset Pricing*, 56 J. FIN. 1533, 1545 (2001).

106 *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 659–60 (1996).

107 Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99, 104 (2005).

108 Loss aversion is a phenomenon where people place more value on losses over gains of the same magnitude. *See* Nicholas Barberis & Ming Huang, *Mental Accounting, Loss Aversion and Individual Stock Returns*, 56 J. FIN. 1247, 1247–48 (2001) (noting that investors are loss averse, rendering them more sensitive to losses than gains).

109 *See* Choi & Pritchard, *supra* note 38, at 17–18 (noting that sophisticated investors are even subject to framing effects, evidenced by analysts giving more favorable forecasts to firms that lowball their earnings).

sophisticated or otherwise, behave is a far cry from perfect rationality. Requiring investors to act as reasonable investors would thus be asking flawed humans to act against their nature. Yet, as stated previously, unless investors can achieve this insurmountable goal, they risk losing the protections of entire sections of securities law.

This rationality assumption also fails to consider the macro context investors are operating in, such as a global pandemic. Specific to *Vaxart* and *Inovio*, expecting investors to behave rationally amid a pandemic might, quite frankly, be unreasonable. When things as inconsequential as weather conditions could affect investing decisions, how is it possible that a global healthcare crisis, such as the COVID-19 pandemic, does not affect an investor's investing decisions relating to companies in the healthcare industry? In this context, it is expected that an actual investor of Inovio or Vaxart, unlike the reasonable investor, is ready to invest in healthcare stocks when a company hints at good news in the headlines without carefully reading the full disclosure. While this is not rational behavior, it is human behavior. More importantly, as explained above, there is evidence that investors do not behave "rationally" in any year, let alone one that upended social norms and market behavior.

Second, the expectation that investors are as knowledgeable as the reasonable investor standard requires should also be challenged. This assumption may even be at odds with the SEC's own findings. An SEC report in 2012 includes a study that shows "U.S. retail investors lack basic financial literacy."[110] The study found that investors do not understand basic concepts such as inflation or more advanced concepts such as the differences between stocks and bonds.[111] According to the report, retail investors are woefully unprepared to avoid investment fraud.[112] Therefore, requiring retail investors to behave as reasonable investors may also require them to acquire extensive knowledge they do not have. Further, because courts assess materiality from the perspective of *homo economicus*, this idealized omniscient investor is currently the chief audience for corporate disclosure. Put differently, in disclosing information, corporations need worry less about whether a typical investor may understand the disclosed information. Under

[110] OFF. OF INV. EDUC. & ADVOC., SEC, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS, at iii (2012), https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf [https://perma.cc/XV2K-MY2X]. Retail investors as used in this context refer to "individuals who invest their own money, typically on their own behalf," whereas institutional investors are organizations who employ professionals to invest on behalf of others. Barclay Palmer, *Institutional Investors vs. Retail Investors: What's the Difference?*, INVESTOPEDIA (Mar. 17, 2022), https://www.investopedia.com/ask/answers/06/institutionalinvestor.asp [https://perma.cc/WC8B-5WGM].

[111] SEC, *supra* note 110, at 7–8.

[112] *See id.* at 3.

this standard, they need only worry about whether their disclosure would pass the courts' muster from the perspective of *homo economicus*. As a result, companies such as Inovio could protect themselves from misleading headlines by burying a short clarifying statement in a long paragraph without even explaining that the selection for a study is not the same as selection for funding.

Curiously, when crafting securities law, Congress seems to recognize that investors are complex, flawed humans. Many provisions of the '33 and '34 Acts account for the irrational decision-making of investors. For instance, Section 5(c) of the '33 Act prohibits all offers prior to the filing of a registration statement.[113] The SEC further clarifies that any publicity that conditions the market or arouses interest in the issuer's security is in violation of this provision.[114] The purpose behind the rule is to prevent irrational market hype.[115] However, if investors were truly rational, they would be able to disregard any attempts by the issuer to arouse unwarranted market interest. Yet, IPO underpricing[116] is still extremely common due in small part to irrational investor exuberance, despite these rules and regulations that are designed to curtail such hype.[117]

The '33 Act and '34 Act were enacted after the stock market crash of 1929 to protect the investing public.[118] It is, therefore, problematic that the standard of materiality limits the scope of the securities law's protection to a subgroup of investors that do not constitute the majority of the investing public or may simply not exist. Preserving a cause of action for only those who are rational and knowledgeable can lead to a lack of investor protection, and gives corporations cover to release more complex, less digestible, and potentially misleading materials that the average investor cannot comprehend.

[113] 15 U.S.C. § 77(e).

[114] Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 850–51 (1959).

[115] *See id.* at 853 ("[T]he danger to investors from publicity . . . may be greater in cases where an issue has 'news value' since it may be easier to whip up a 'speculative frenzy' concerning the offering . . . .").

[116] A new stock is underpriced when it closes its first day of public trading above the IPO price. It is extremely common. *See* Steven Davidoff Solomon, *Why I.P.O.'s Get Underpriced*, N.Y. TIMES, (May 27, 2011, 10:48 AM), https://archive.nytimes.com/dealbook.nytimes.com/2011/05/27/why-i-p-o-s-get-underpriced/ [https://perma.cc/C387-5G6Y] ("I.P.O. underpricing is ubiquitous.").

[117] Chee Keong Low, *The Duties of Directors in "Irrationally Exuberant" Initial Public Offerings*, 2 VA. L. & BUS. REV. 89, 93 (2007). Although, irrational investor exuberance is certainly not the only reason behind IPO underpricing.

[118] *See Securities Law History*, CORNELL L. SCH., LEGAL INFO. INST., https://www.law.cornell.edu/wex/securities_law_history [https://perma.cc/Y7AL-YKLZ].

III. THE REASONABLE PERSON VERSUS THE AVERAGE PERSON

The reasonable investor standard is not without analogues in the law. An obvious antecedent would be tort law's "reasonable person" standard. At first blush, the two standards share many similarities. But as this Part will argue, there are crucial differences between securities law and tort law that exemplify the unique impracticability of the standard to securities claims. Instead, securities law should borrow from the average person standard, as adopted by the Supreme Court in First Amendment jurisprudence.

A. The Reasonable Person Standard in Tort Law

Like statutory securities law, tort law frequently requires triers of fact to assume the identity of a hypothetical reasonable person to determine if a litigant acted with sufficient care.[119] The reasonable person standard has significant benefits. In *Vaughan v. Menlove*, the court rejected the subjective standard that asks whether a litigant "acted honestly and bona fide to the best of his own judgment" and adopted an objective standard that determines liability based on the caution a man of ordinary prudence would observe.[120] An objective standard aids administrability by eliminating problems of proof that a subjective standard presents.[121] At the same time, the standard allows for flexibility in responding to various circumstances.[122] Additionally, the reasonable person standard has been applauded for incentivizing individuals to act with ordinary care as a reasonable person would.[123]

At first glance, the reasonable person standard appears similar to the reasonable investor standard. Both are objective standards, and both require a highly contextualized analysis. In addition, the effectiveness of both standards hinges on how easily lay juries and judges can channel the respective protagonists. Herein lie the differences between tort and securities law.

In simple tort cases, such as negligent driving or premises liability, juries are viewed as uniquely competent to determine what it means to be reasonable.[124] Through collective wisdom, juries can mitigate the uncertainty inherent in the standard.[125] However, the issues with which juries deal in tort law are closely related to everyday life—scenarios that jurors have likely

[119] *See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 3 cmt. a (2010).

[120] (1873) 132 Eng. Rep. 490, 493.

[121] Rose, *supra* note 14, at 83.

[122] *See id.*

[123] *Id.*

[124] *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 450 n.12 (1976).

[125] Rose, *supra* note 14, at 80.

experienced or can easily imagine. Securities investing, on the other hand, is not such an issue.

As the Supreme Court observed, the typical fact pattern in even common law misrepresentation is "light years away from" the type of transactions at issue in securities litigation.[126] While most people understand the safety precautions required during car travel, as of 2016 only 14% of American families directly invested in stocks.[127] Most jurors likely have never reviewed a corporate disclosure statement.[128] Given their lack of familiarity with the subject matter and overall lack of financial literacy,[129] most lay juries do not sufficiently understand the goings-on in a securities transaction to offer collective wisdom.

It is worth noting that judges are no more adept at assessing investor behavior. There is no evidence that judges possess a more sophisticated understanding of markets or investor behavior than the average juror.[130] In fact, scholars observe that in securities cases, judges are often making materiality determinations based on "judicial hunches."[131]

In tort cases involving specialized activities, such as securities investment, expert witnesses are often called upon to frame what constitutes reasonableness in their specific fields.[132] Here again, the analogy breaks down. Expert testimony is unlikely to be meaningful in materiality determinations under the reasonable investor standard because the reasonable investor cannot be found and asked to take the stand. In the small subset of securities cases that go to trial, Wall Street analysts,[133] investment

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[126] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744–45 (1975).

[127] Jesse Bricker et al., *Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances*, FED. RSRV. BULL., Sept. 2017, at 18 tbl.3, https://www.federalreserve.gov/publications/2017-September-changes-in-us-family-finances-from-2013-to-2016.htm [https://perma.cc/5ZSP-JQXD]. The same government data shows that over half of American families hold some market investment through owning retirement accounts. *Id.*

[128] In fact, even disclosures prepared by investment companies for their clients often go unread. *See* Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 1009 (2008).

[129] *See supra* note 110 and accompanying text.

[130] *See* Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 120 (2002).

[131] *See* Hoffman, *supra* note 29, at 607.

[132] Anjelica Cappellino, *What Is the Role of an Expert Witness in a Negligence Claim?*, EXPERT INST. (Apr. 27, 2022), https://www.expertinstitute.com/resources/insights/what-is-the-role-of-an-expert-witness-in-a-negligence-claim/ [https://perma.cc/K92L-9LJT].

[133] United States v. Schiff, 602 F.3d 152, 171 n.26 (3d Cir. 2010) (noting that the government has Wall Street analysts as fact witnesses who would "testify that a pharmaceutical company's sales and the level of wholesaler inventory are material to their investment decisions").

or accounting experts, and lawyers[134] are called on to opine on materiality. But such specialists are decidedly not stand-ins for the reasonable investor, who does not have the financial expertise of trained professionals.[135]

Not only is the reasonable investor standard less administrable than the reasonable person standard, it is also more likely to cause harm. The reasonable person standard assesses the behavior of *defendants* in negligence cases. It, therefore, incentivizes individuals to act with ordinary care as a reasonable person would in fear of liability. The reasonable investor standard, however, is used to assess the behavior of possible *victims*. Instead of asking whether the defendants acted within the realm of reasonableness, it is assessing whether market reaction, which is the collective action of victims, aligns with that of a reasonable investor. It requires the less powerful party to review and react to every issuer statement as a reasonable investor would or risk losing their cause of action.[136] Instead of incentivizing good behavior, the reasonable investor standard functions as an excuse. It is a chance for companies to point to the inadequacies of an investor's behaviors. It allows—and perhaps even encourages—companies to play with clever wording to achieve the effects of market manipulation or deception while hopefully avoiding liability.

Given the differences between tort and securities law, it is not sufficient to model a materiality standard after the reasonable person standard. We are left to look for a solution. The Supreme Court provided one possible solution in a different area of jurisprudence: the First Amendment.

B. The Miller *Test and the Average Person Standard*

First Amendment jurisprudence balances the right to freedom of speech against the state's authority to limit certain speech. One category of speech that may be limited is obscenity, which often occurs in the context of literature or art. The Supreme Court has always struggled with articulating a standard for obscenity under the First Amendment. In *Jacobellis v. Ohio*, Justice Potter Stewart famously declared the incredibly vague standard, "I know it when I see it."[137] Almost a decade later, the Court adopted the *Miller* test, which remains, to this day, the standard to assess the constitutionality

[134] United States v. Reyes, 577 F.3d 1069, 1075 (9th Cir. 2009) (noting that the government presented expert testimony from a portfolio manager, a proxy lawyer, and an accounting expert).

[135] *See* Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991) (observing that a mixture of truth will not neutralize deception "[i]f it would take a financial analyst to spot the tension between the one and the other").

[136] *See supra* Section II.D.

[137] 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

of state regulations against obscenity. Under the *Miller* test, a trier of fact must determine:

> (a) whether "the average person, applying contemporary community standards" would find that the work, taken as a whole, appeals to the prurient interest; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value.[138]

The standard is not without critics.[139] Yet, the standard, especially the Court's later adjustment of the standard in *Pope v. Illinois*, provides inspiration for securities law. In *Pope v. Illinois*, the Court stated that while the first two prongs of the *Miller* standard adhere to the "ordinary member of the community" standard, the third prong should follow the "reasonable person" standard instead.[140] The adjustment importantly illustrates that the Court recognizes a difference between the "average person" and the "reasonable person."

This, of course, raises a question: why did the Supreme Court think it was necessary to articulate two different standards in the context of First Amendment jurisprudence? Note, the Court only uses "reasonable person" when asking if a piece of work has "value." Moreover, the Court reasoned that the value of a piece of work, like the ideas it represents, does not need to receive "majority approval" to receive First Amendment protection.[141] Implicit is the belief that a reasonable person finding value in a piece of work is not the same as a work having majority approval. The Court is thus suggesting that a reasonable person might find value in something "an ordinary member of any given community" might not.[142] Implicit in the Court's reasoning is that a reasonable person's judgment could possibly not match that of an ordinary person. The Court realizes that a reasonable person is not necessarily an ordinary or average person in terms of cognition. While the Court might have been focusing more on the "contemporary community" and the locality aspect of the test in its analysis,[143] the fact that the *Miller*

138 Miller v. California, 413 U.S. 15, 24 (1973) (citation omitted) (quoting Kois v. Wisconsin, 408 U.S. 229, 230 (1972)).

139 *See, e.g.*, *id.* at 39–42 (Douglas, J., dissenting); Pope v. Illinois, 481 U.S. 497, 504–05 (1987) (Scalia, J., concurring) (suggesting that the standard roughly equates to seeking a nebulous "man of tolerably good taste" and proposing a reevaluation of *Miller*).

140 481 U.S. 497, 500–01 (1987).

141 *Id.* at 500.

142 *See id.*

143 Given that the *Miller* test assesses whether *state* prohibitions on certain works are constitutional, it makes sense that locality is an issue.

standard utilizes the phrase "average person" rather than "reasonable person," when the latter is undoubtedly available, is telling.

In tort law, the difference between the reasonable person and the average person might not be as pronounced, because many of the issues in tort law involve everyday occurrences in which acting "reasonably" requires merely ordinary care. Being particularly logical or knowledgeable does not make a driver more or less likely to stop at the sight of a pedestrian crossing the street. Therefore, distinguishing between reasonable and average in the law of torts is less beneficial.

However, evaluating the importance of pieces of investment information, similar to valuing works of literature or art, involves cognitive skills. As the Supreme Court observed, the average person and the reasonable person could differ in this aspect. In the art and literature context, the reasonable person, in the eyes of the Court, is likely more knowledgeable, sophisticated, and cognitively skillful.[144] All of these characteristics contribute to the reasonable person's ability to judge the intangible value of art. Assessing market information likewise requires a combination of knowledge and cognitive abilities. It would seem equally compelling, then, to differentiate between average and reasonable in the securities law, as the Court does in First Amendment jurisprudence.[145] While courts have not yet recognized the "average investor," it is not a radically novel concept in legal scholarship.[146] This Note proposes that courts adopt this concept and craft a materiality standard centered on the average investor.

[144] *Pope* shows that the Court is seeking to expand the protection of the First Amendment. *See* 481 U.S. at 501. In its effort to do so, the Court adjusted the "value" prong of the *Miller* test and adopted the "reasonable person" language. *Id.* at 500–01. This change implies that the Court believes the reasonable person can find value in some works of art and literature when the average person cannot. As such, it appears that in the eyes of the Court, the reasonable person possesses superior cognitive capabilities, at least when it comes to art.

[145] Some courts have incorrectly used "reasonable investor" and "ordinary investor" interchangeably. *See, e.g.*, Miller v. Thane Int'l, Inc., 519 F.3d 879, 886 (9th Cir. 2008) (describing a "fair and reasonable implication an ordinary investor would derive" from information in a given case).

[146] *See, e.g.*, Lin, *supra* note 14, at 469 (recognizing the various types of investors in a market and identifying "the irrational investor" as being "premised on the *homo sapien*, the flawed, *ordinary* individual of the real world" (emphasis added)). The average retail investor in an efficient market shares the same attributes as Professor Lin's ordinary irrational investor. Although, the characteristics of the average investor could change depending on the market.

IV. THE AVERAGE INVESTOR STANDARD

Scholars have proposed various reforms to the reasonable investor standard.[147] Indeed, it's possible to fine-tune the standard without fundamental changes to enhance investor protection. For instance, regulators and courts could determine a nonexhaustive list of factors that should guide a reasonableness analysis, including market conditions such as those described by the *Vaxart* court. This Note recommends replacing the reasonable investor standard with the average investor standard in efficient markets.[148] This reform would fundamentally improve the predictability of materiality determinations and protection afforded to the investing public is needed. The proposed standard is as follows: A misrepresentation or omission is material if there is a substantial likelihood that it would be regarded as important *by "the average investor" in the specific market at that time*. This is a novel proposal that builds on reforms proposed by Professor Lin, which start from acknowledging the variety of investors in the real world.[149] However, while Professor Lin only recommends that policymakers recognize all types of investors when crafting securities regulation, this Note proposes an overhaul of the standard for materiality.

A. Applicability

Such a standard has the benefits of applicability and flexibility and is better able to protect investors. To be sure, it is not suggested that the proposed standard will change the outcome of litigation in a great majority of cases. Indeed, there are many instances where one would expect the reasonable investor standard and the average investor standard to lead to the

[147] *See, e.g.*, Lin, *supra* note 14, at 513 (recommending the addition of "an algorithmic investor typology" to materiality considerations); Sachs, *supra* note 5, at 503 (proposing the "least sophisticated investor" standard as an alternative to the current standard in inefficient markets); Rose, *supra* note 14, at 110 (suggesting clearly identifying the reasonable investor as a possible reform).

[148] "A market in which prices always 'fully reflect' available information is called 'efficient.'" Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970). This Note follows *Basic* and focuses on efficient and semi-efficient markets in which price, at least somewhat, reflects available information. *See* Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988) ("[T]he market price of shares traded on well-developed markets reflects all publicly available information and, hence, any material misrepresentations.").

[149] Lin, *supra* note 14, at 515 (advocating that "[t]he introduction of the algorithmic investor typology can lead to a better conception and application of materiality, particularly in the context of securities litigation"). Professor Lin describes six different types of investors, each differing in cognition, activism, wealth, and personage. *Id.* at 466–76, 499. The six types are the reasonable investor, the irrational investor, the active investor, the sophisticated investor, the entity investor, and the algorithmic investor. His article contends that a "dissonance between investor heterogeneity in reality and investor homogeneity in regulation" creates discontent for regulators and investors in financial markets. *See id.* at 464. He further advocates for recognizing the new "algorithmic investor" to guide future rulemaking. *Id.* at 515.

same materiality determination. That said, in a subset of cases where the reasonable investor standard poses greater challenges, the average investor standard will lead to better results for investors.

The reasonable investor standard is unpredictable and difficult to apply because the reasonable investor is difficult to identify. However, the average investor could be identified through simple, verifiable market research. For example, a poll of a certain investment market would inform companies and courts alike of the level of knowledge and wealth, as well as the identity of the average investor, in that market. With a clear depiction of the average investor, expert witnesses, such as economists or psychologists, could apply scientific analysis to opine on that individual's possible reactions to a certain piece of information. Instead of channeling an elusive figure and trying to imagine activities they do not understand, under the average investor standard, jurors will do what they do best—judge credibility.

In addition, the average investor standard can have the salutary effect of rendering objective evidence, such as stock market reaction, more persuasive. Currently, stock market reaction is often just one piece of evidence submitted to guide a materiality determination.[150] The jury is then asked to imagine, given the evidence before them, how the reasonable investor would or should have reacted. But if the Court were to adopt the average investor standard, stock market reaction can be presented as how the majority of the market *did* react.

Under the average investor standard, *Vaxart* would have been rightly decided. All the factors, such as abnormal market hype and investor emotions, on which the *Vaxart* court incorrectly relied under the reasonable investor standard would be permissible under this approach. It is realistic that the average investor is affected by the hype surrounding pharmaceutical companies when the pandemic was one of the most important news topics. It is likewise realistic that the average investor was excited by the mere mention of Operation Warp Speed. And it is realistic that the average investor jumped to the conclusion that Vaxart was about to receive government funding when the company's announcement was released. Thus, the investing public would receive protection under the law. Conversely, the *Inovio* court would have erred in failing to consider the full context in which average investors were operating at the time.

150 *See* Veleron Holding, B.V. v. Morgan Stanley, 117 F. Supp. 3d 404, 433 (S.D.N.Y. 2015) (noting that in the Second Circuit, price impact is a part of the "evidentiary mix" in securities practice). There is, however, a circuit split as to whether stock price movement is dispositive of materiality. *See In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997) (noting that price movement is dispositive of materiality).

B. Predictability

In addition to relieving juries of an unenviable task, elevating the importance of objective evidence such as stock market reaction would provide greater consistency and uniformity across circuits. In doing so, the standard provides some predictability to materiality determinations. Note that event studies, statistical analyses used to determine whether an action by a company is associated with a change in its stock price,[151] will be required to unpack whether a market reaction is determinative of materiality. As they are statistical analyses and not legal constructs, event studies do not vary from jurisdiction to jurisdiction. Therefore, determinations relying on event studies should yield similar results in Pennsylvania and California.

Under the reasonable investor standard, companies are incentivized to predict what a judge or juror considers the appropriate response of a reasonable investor. By drawing a closer correlation between stock market reactions and materiality, companies need only predict how the market will react to disclosure. While this might not be easy, companies certainly have more experience with and data on markets. More importantly, decreasing ambiguity would simultaneously decrease the incentive for companies to craft clever disclosures that might be just clear enough to avoid misleading the *homo economicus*.

It is important to realize that relying on objective evidence in securities litigation is not novel. In fact, courts often afford great weight to price impact and stock market reaction when deciding other elements of securities fraud, such as loss causation, reliance, and damages.[152]

C. Flexibility

While the Court agrees that materiality determinations should be made based on an objective standard,[153] the standard must be flexible enough to apply in many situations. As a result, the Court refused to instigate a bright-line rule.[154] Like the reasonable investor standard, the average investor standard is also a "fact-specific inquiry."[155] On top of that, instead of

151 *Event Study*, WORLD BANK, https://dimewiki.worldbank.org/Event_Study [https://perma.cc/7FRJ-ZXBR].

152 Jill E. Fisch, Jonah B. Gelbach & Jonathan Klick, *The Logic and Limits of Event Studies in Securities Fraud Litigation*, 96 TEX. L. REV. 553, 555 (2018) ("[P]rice impact is critical to other elements of securities fraud, including loss causation, materiality, and damages.").

153 *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 445 (1976) ("The question of materiality, it is universally agreed, is an objective one . . . .").

154 *See* Basic Inc. v. Levinson, 485 U.S. 224, 239 (1988); Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 43 (2011).

155 *Basic*, 485 U.S at 240.

centering around one type of investor, the standard looks at the average investor in each specific market.

The *Miller* test in First Amendment jurisprudence is designed to assess various state-level speech laws, which requires flexibility to respond to different community values. The inclusion of the words "applying contemporary community standards" allows the standard to do just that.[156] Similarly, by specifying that the standard is focusing on investors in a specific market at a specific time, the average investor standard is flexible enough to capture the special circumstances of various investment markets. For example, the average investor would be different in the bond market compared to the stock market. Moreover, restrictions are placed on certain types of transactions, such as a Regulation D Rule 506 offering[157] and a Rule 144A resale.[158] Regulations dictate that all investors in such transactions must possess a certain level of sophistication. The average investor in these transactions is thus different than that in the regular stock market. While the reasonable investor standard cannot account for "the diverse profiles of real investors," the average investor standard can.[159]

Additionally, the "specific market at the time" language which is parallel to the *Miller* test's "contemporary community" language allows the standard to account for more context-specific factors in markets. An obvious example would be how the average investor is likely more sensitive and prone to irrationality when it comes to pharmaceutical companies during a pandemic. The average investor standard would also be able to consider new trading strategies such as algorithmic trading,[160] in which case it could be argued the investor is not even human.

[156] Miller v. California, 413 U.S. 15, 24 (1973) (quoting Kois v. Wisconsin, 408 U.S. 229, 230 (1972)).

[157] In an offering under Rule 506 of Regulation D, companies can only sell securities to accredited investors or any of thirty-five nonaccredited investors that possess high levels of sophistication. *See* 17 C.F.R. § 230.506 (2021).

[158] SEC Rule 144A allows the resale of unregistered securities to qualified institutional buyers only. 17 C.F.R. § 230.144A (2020).

[159] Lin, *supra* note 14, at 476. See *supra* note 149 and accompanying text for a discussion of the various types of investors. As Professor Lin notes, the current reasonable investor standard is based on a "singular paradigm" of investors. Lin, *supra* note 14, at 476. The dissonance between this standard and the world of real investors "hinder[s] . . . the soundness of financial regulation." *Id.*

[160] Algorithmic trading or automated trading uses a computer program that follows an algorithm to place a trade. *See* CFI Team, *Algorithmic Trading*, CORP. FIN. INST. (Oct. 16, 2022), https://corporatefinanceinstitute.com/resources/equities/algorithmic-trading/ [https://perma.cc/2KLR-Y5GZ].

D. Investor Protection

Unlike the reasonable investor standard, the average investor standard does not require investors to conform their actions to that of anyone other than themselves. Like the reasonable person standard in tort law, the average investor standard would incentivize companies to carefully consider the effects of a misstatement or omission or even a misleading presentation of information that is "literally true."[161]

Some might be concerned that lowering the bar on materiality could potentially increase meritless securities lawsuits, which Congress enacted the Private Securities Litigation Reform Act (PSLRA) to prevent.[162] Some would argue that companies cannot accurately predict the reaction of the market, and should the market react in an unexpected fashion, companies could be subject to vexatious securities litigation, which is typically very costly.

However, materiality, while key, is not a stand-alone element in any cause of action under the '33 Act and '34 Act. For instance, scienter, or an "intent to deceive, manipulate, or defraud,"[163] is an element of a Rule 10b-5 claim. The PSLRA imposes heightened pleading standards for the scienter element, requiring a strong inference.[164] A showing that a company carefully considered but ultimately misjudged the effects of its statements could refute any suggestion of scienter. To be sure, there is still the Court's concern in *Northway* that a low standard of materiality will result in companies burying investors with trivial information. However, as mentioned above, Congress adopted the PSLRA, which did not exist at the time of *Northway*, to prevent unnecessary litigation. It is questionable whether companies will become more fearful of liability after a change in the materiality standard. In addition, silence, when there is no duty to disclose, is not in and of itself actionable.[165] Yet, when a company decides to disclose information, it must make sure the information is not misleading given the "total mix" of information available.[166] Furthermore, when a previous disclosure is no longer accurate,

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161 *In re* Vaxart, Inc. Sec. Litig., 576 F. Supp. 3d 663, 671 (N.D. Cal. 2021).

162 James Chen, *Private Securities Litigation Reform Act (PSLRA)*, INVESTOPEDIA (July 18, 2022), https://www.investopedia.com/terms/p/pslra.asp [https://perma.cc/QGT6-RCNJ] ("The Private Securities Litigation Reform Act (PSLRA) is a piece of legislation passed by Congress in 1995 to stem the filing of frivolous or unwarranted securities lawsuits."); Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4.

163 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

164 Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 321 (2007) ("Under the PSLRA's heightened pleading instructions, any private securities complaint . . . must . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").

165 Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988).

166 *Id.* at 232.

it is generally accepted that a company has a duty to correct and a duty to update.[167] The more a company discloses, the more it has to monitor, and the more it is likely to need to correct and update. As such, providing excessive and unnecessary information increases a company's compliance costs, as it will need to expend time and effort to confirm the validity and appropriateness of each disclosure. Therefore, the incentive for companies to disclose as much as possible is somewhat curtailed.

Instead of encouraging more trivial disclosures, the average investor standard encourages cautious disclosure. It requires companies to think about their actual and potential investors and carefully craft disclosure to make sure their audiences can access accurate information. Congress specifically enacted the '33 Act and '34 Act after the stock market crashed in 1929, leading to the Great Depression. Congress designed both pieces of legislation to ensure market transparency and protect investors.[168] While the reasonable investor standard incentivizes companies to search for an excuse by focusing on materiality, the average investor standard is in line with the legislative intent and compels truthful disclosure.

CONCLUSION

The *Northway–Basic* standard remains a crucial development in securities law. Because it facilitates class action,[169] its importance for investor protection cannot be undermined. However, the standard has obvious drawbacks that stem from the elusive nature of its protagonist, the reasonable investor.

This Note proposes a new standard that builds upon the *Northway–Basic* standard but centers around the average investor. The average investor standard determines materiality based not on who investors could be but on who investors currently are. By doing so, the standard is easier to apply, is more flexible, renders more consistent results, and better protects investors in alignment with the legislative intent of the '33 Act and '34 Act.

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167 Robert H. Rosenblum, *An Issuer's Duty Under Rule 10b-5 to Correct and Update Materially Misleading Statements*, 40 CATH. U. L. REV. 289, 290 (1991).

168 *See The Laws That Govern the Securities Industry*, SEC, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry [https://perma.cc/3LM5-SB9G].

169 Sachs, *supra* note 5, at 486.