TESTING GOOD SECURITIES DISCLOSURE: TALES OF THE REASONABLE INVESTOR

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The reasonable investor test has developed in Australia both in the law of misleading and deceptive conduct in relation to securities and in the enquiry into the materiality of information in the stock market context. The former involves the question of whether a reasonable investor would have been influenced by misleading conduct, whereas the latter involves the question of whether a reasonable investor or person would expect that information would have caused investors to trade or otherwise act (the two issues can clearly be related). The test raises various issues including how it applies to a diverse class and whether it is interchangeable with a market test (the writer argues it is not). The test also exists in the United States and has been raised, but then specifically rejected, by the courts in Ireland. The development of behavioural law and economics leads to the question of whether the test can, or should, be modified in view of the allegedly non-rational attributes of investors. The author argues that the test has sufficient flexibility to accommodate such attributes in appropriate cases.

I INTRODUCTION

The 'reasonable investor' and associated tests (such as the 'reasonable shareholder') appear in Australian and overseas case law and legislation in a variety of forms and for a variety of purposes, though generally with the overarching purpose of testing the effectiveness of securities market disclosure. The issue is important with continuing high levels of participation in the stock market[1] and the desirability of providing some protection to both sophisticated and unsophisticated investors. The test is a 'reasonable person' test hypothesising a typical investor for the purpose of judging conduct objectively. The 'reasonable investor' test utilises a fictional person developed by the common law and is thus a more specialised version of the 'reasonable person'[2] test by which individuals'

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1 See generally Australian Securities Exchange, *2010 Australian Share Ownership Study* (2011) <http://www.asx.com.au/documents/resources/2010_australian_share_ownership_study.pdf>.

2 Sometimes characterised as 'the man on the Clapham Omnibus' as in *Hall v Brooklands Auto Racing Club* (1933) 1 KB 205, 224. A reasonably educated and intelligent but non-specialist ordinary person.

actions, particularly in negligence law, are judged by objective standards.[3] In tort law in England and Australia the reasonable person has been identified as being of ordinary prudence,[4] utilising ordinary care and skill,[5] and a hypothetical person.[6] The reasonable investor doctrine has been utilised in Australia in assessing whether conduct or representations would mislead shareholders (the misleading conduct enquiry) and also whether conduct or representations would cause a person to expect that other shareholders would buy or sell shares on the basis of those representations (the materiality enquiry).

In this article I will examine the tests and judicial comment thereon and exposition thereof. I will note the principal uses of the test and examine the alternate 'market' test, as well as the arguable effect of behavioural law and economics on the reasonable investor concept. I will conclude that the latter has sufficient flexibility to take on the insights of the behaviouralists and is a superior test to the market test. In that regard I will note the court's ability to adopt a reasonable *retail* or unsophisticated investor test in appropriate circumstances and even to vary the level of rationality and other characteristics of such investor as the facts, circumstances and parties before the court may demand.

II REASONABLE MEMBERS OF THE CLASS

In stock market cases of misleading conduct, the 'reasonable person' will be a reasonable member of the class of persons who may buy shares in a particular company or companies. The case of *Campomar Sociedad Limitada v Nike International Ltd*[7] in 2000 illustrates the trend of misleading and deceptive conduct cases which have traditionally focused on misleading statements to identified persons, but which in some cases focus on misleading statements directed to particular groups of persons or to 'the public' at large. The focus therefore is on a reasonable member of that class. Though that case concerned a trade mark dispute, the principles developed can be applied where any misleading misrepresentations are directed toward members of the public and it becomes necessary to postulate a reasonable member or members of that public for the purposes of interpreting those representations. The members of the High Court (Gleeson CJ, Gaudron, McHugh, Gummow, Kirby, Hayne and Callinan JJ) noted as follows:

3 The reasonable person standard first appears in English law in *Vaughan v Menlove* (1837) 3 Bing NC 468; 132 ER 490 where the defendant farmer stacked hay on his property in a manner prone to cause spontaneous combustion which later occurred. The lawyer argued his client's low intelligence but said he acted '*bona fide* [and] to the best of his [own] judgment'. The Court disagreed, reasoning that such a standard would be too subjective, and instead preferred to set an objective standard by which it could adjudicate such cases.

4 *Vaughan v Menlove* (1837) 3 Bing NC 468, 475; 132 ER 490, 493 (Tindal CJ).

5 *Heaven v Pender* (1883) 11 QBD 503, 507 (Brett MR).

6 *King v Phillips* [1953] 1 QB 429, 441 (Denning LJ).

7 (2000) 202 CLR 45 ('*Nike*').

> Where the persons in question are not identified individuals to whom a particular misrepresentation has been made or from whom a relevant fact, circumstance or proposal was withheld, but are members of a class to which the conduct in question was directed in a general sense, it is necessary to isolate by some criterion a representative member of that class. The inquiry thus is to be made with respect to this hypothetical individual why the misconception complained has arisen or is likely to arise if no injunctive relief be granted. In formulating this inquiry, the courts have had regard to what appears to be the outer limits of the purpose and scope of the statutory norm of conduct fixed by s 52. Thus, in *Puxu*, Gibbs CJ observed that conduct not intended to mislead or deceive and which was engaged in 'honestly and reasonably' might nevertheless contravene s 52. Having regard to these 'heavy burdens' which the statute created, his Honour concluded that, where the effect of conduct on a class of persons, such as consumers, was in issue, the section must be 'regarded as contemplating the effect of the conduct on reasonable members of the class'.[8]

The *Nike* case concerned a dispute over the use of the name 'Nike' between a sports fragrance company and an athletic shoe distributor, both of whom had registered the name as a trademark. In somewhat similar vein in *Taco Company of Australia Inc v Taco Bell Pty Ltd*,[9] the Full Court of the Federal Court analysed the effect of misleading conduct upon the public in the context of a passing off allegation where two companies each claimed the right to use the name and style of 'Taco Bell'. Deane and Fitzgerald JJ stated the following propositions in relation to the effect of a misleading representation:

> First, it is necessary to identify the relevant section (or sections) of the public (which may be the public at large) by reference to whom the question of whether conduct is, or is likely to be, misleading or deceptive falls to be tested (*Weitmann v Katies Ltd* (1977) 29 FLR 336, per Franki J at 339–40, cited with approval by Bowen CJ and Franki J in *Brock v Terrace Times Pty Ltd* (1982) 40 ALR 97 at 99; [1982] ATPR 40-267 at 43,412).
>
> Second, once the relevant section of the public is established, the matter is to be considered by reference to all who come within it, 'including the astute and the gullible, the intelligent and the not so intelligent, the well educated as well as the poorly educated, men and women of various ages pursuing a variety of vocations': *Puxu Pty Ltd v Parkdale Custom Built Furniture Pty Ltd* (1980) 31 ALR 73, per Lockhart J at 93: see also *World Series Cricket v Parish*, supra, per Brennan J (16 ALR at 203).
>
> Thirdly, evidence that some person has in fact formed an erroneous conclusion is admissible and may be persuasive but is not essential. Such evidence does not itself conclusively establish that conduct is misleading or deceptive or likely to mislead or deceive. The court must determine that question for itself. The test is objective (see, generally, *Annand &*

8 Ibid 85 [103] (citations omitted).

9 (1982) 42 ALR 177 ('*Taco Bell*').

> *Thompson Pty Ltd v Trade Practices Commission* (1979) 25 ALR 91 per Franki J at 102; *Sterling v Trade Practices Commission* (1981) 35 ALR 59, per Franki J (with whom Northop J agreed) at 66 and per Keely J at 69; *Snoid v Handley* (1981) 38 ALR 383, per the court (Bowen CJ, Northrop and Morling JJ); and *Brock v Terrace Times*, supra per Bowen CJ and Franki J).[10]

III THE REASONABLE INVESTOR AND MATERIALITY

Closely related to the concept of whether a reasonable investor would be misled by statements or conduct is the issue of whether a reasonable investor would be influenced by such conduct to buy or sell shares or refrain from buying or selling shares. The latter enquiry is whether the conduct or information is material. In US securities law the reasonable investor is also the judge of what is material, ie what influences investors to buy, sell, vote or otherwise act on information. In *TSC Industries Inc v Northway Inc*,[11] the US Supreme Court found that the results of drilling, which indicated a strong possibility (although not a certainty) of a significant mineral discovery was material to the reasonable investor. The Court stated that information was material

> if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding [how to exercise voting rights attached to its shares] ... Put another way, there must be a substantial likelihood that the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.[12]

The *TSC* authority has also been expressly applied in Australia in *Riley v Jubilee Mines NL* though Master Sanderson made reference to the test as a 'reasonable person' test.[13] That case concerned Jubilee Mines NL ('Jubilee') a listed gold exploration company which in 1993, acquired a tenement known as McFarlanes Find. In August and September 1994, Jubilee received notification from a neighbouring tenement holder, Western Mining Corporation Ltd ('WMC'), concerning the results of drilling that WMC had mistakenly carried out on McFarlanes Find. These results showed nickel sulphide dissemination at substantial depths. Jubilee did not disclose these matters to the market until June 1996. On disclosure the Jubilee share price rose some nine per cent. Jubilee had traditionally been a gold miner and there was evidence that it did not have cash to develop a nickel mine despite the resource and did not intend to develop that mine.

Riley (being a holder of both partly and fully paid shares in Jubilee) succeeded in a claim brought under s 1005 of the *Corporations Law* for loss and damage suffered by reason of a failure to immediately disclose the information to the

10 Ibid 202.

11 426 US 438 (1976) (Marshall J) ('*TSC Industries*').

12 Ibid 449.

13 (2006) 59 ACSR 252, 312 [290].

market in contravention of s 1001A of the *Corporations Law* (the then continuous disclosure provision). In that decision Master Sanderson specifically approved of the reasonable investor test from the US *TSC Industries* case. On appeal however the Court of Appeal set aside the judgment at first instance finding that s 1001D did not require that the information should have a 'material' effect on the share price.[14] Rather, the Court found that the effect of the section was to obviate the need to address the question of whether a reasonable person would expect a 'material' effect on price to be produced by deeming that question to be answered in the affirmative if the information would, or would be likely to, influence persons who commonly invest in the relevant securities in deciding whether or not to subscribe for or buy or sell those securities. The Court found that a contravention of the relevant Australian Stock Exchange ('ASX') Listing Rules was a pre-requisite to any contravention of the *Corporations Law*.[15]

The Court found as a matter of fact, that Jubilee had no intention of undertaking exploratory drilling on the McFarlanes Find tenement in 1994 and therefore it had no obligation to disclose the information provided by WMC in 1994.[16] It further found that, standing in the shoes of the 'hypothetical investor' nominated by s 1001D and taking into account the relevant evidence, an announcement by Jubilee of all relevant information pertaining to the WMC drill hole data with respect to McFarlanes Find would not, or would not have been likely to, influence persons who commonly invest in securities in deciding whether or not to buy or sell its shares. Accordingly, s 1001D 'did not operate to require Jubilee to disclose any information relating to the data provided by WMC until June 1996'.[17]

The view that the reasonable person test is the primary source for determining materiality was however made clear again in *Australian Securities and Investments Commission (ASIC) v Fortescue Metals Group Ltd [No 5]*,[18] where the Court distinguished between 'ex ante' and 'ex post' materiality.[19] That is, materiality must be determined on a forward looking basis rather than looking at share price movements and working backwards. This meant that it was for the Court to determine what would have happened at the time (using the reasonable shareholder) rather than looking at the effect of later disclosures on the share price and applying this retrospectively. The Court did admit however that evidence of actual effect of share price disclosures on the share price may be relevant to the Court, as a 'relevant cross check as to the reasonableness of an ex ante judgment about a different hypothetical disclosure.'[20]

The *Fortescue* case concerned announcements of the existence of three contracts between Fortescue Metals Group ('FMG') and Chinese building and construction

14 *Jubilee Mines NL v Riley* (2009) 253 ALR 673 ('*Jubilee*').

15 Ibid [41], [61].

16 Ibid [106], [114].

17 Ibid [123].

18 (2009) 264 ALR 201 ('*Fortescue*').

19 Ibid 301 [474].

20 Ibid 301 [477], quoting *Australian Securities and Investments Commission v MacDonald [No 11]* (2009) 230 FLR 1, 168 [1067].

companies to construct a railway, port and mine to facilitate development of a new mine in the Pilbara in Western Australia. Following the publication in *The Australian Financial Review* of an article indicating that these were merely framework agreements that could not be relied upon, the share price fell and the Australian Securities and Investments Commission ('ASIC') commenced proceedings for a failure to make continuous disclosure and for misleading and deceptive conduct. ASIC was unsuccessful in its proceedings before Gilmour J at first instance, the Court finding, inter alia, that the disclosures by Fortescue were of opinions honestly and reasonably held at all relevant times.[21]

On appeal however the Full Court of the Federal Court reversed the lower court's finding and found that FMG had contravened ss 674(2) and 1041H of the *Corporations Act 2001* (Cth).[22] It also found that the managing director of FMG, Andrew Forrest, was knowingly involved in the breach of continuous disclosure provisions and was therefore in breach of his duties to the company under s 180(1) of the *Corporations Act 2001* (Cth).

The case made it clear that the test of materiality related to whether a reasonable person would expect 'common investors' to be influenced by the non-disclosures. The concept of common investors comes from the wording of s 677 which defines a 'material effect' of information on price as occurring where reasonable persons expect that 'it would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of' the securities in question.

Interestingly, evidence of what common investors would think was provided in *Fortescue* by an experienced share portfolio manager, an experienced stockbroker and an expert in business statistics. This level of expertise may to some degree blunt the conception of the reasonable investor as an 'ordinary' or 'common' investor (though the use of the word 'common' may relate to a relatively frequent investor rather than a relatively unsophisticated investor).

The appeal court did however refer to both *Nike* and *National Exchange v Australian Securities and Investments Commission*,[23] and stated that:

> The issue which arises under both s 1041H and s 52 of the *TPA* is what ordinary and reasonable members of the investing public would have understood from FMG's announcements. It is the effect of a statement upon the persons to whom it is published, rather than the mental state of the publisher, which determines whether the statement is misleading or deceptive, or likely to mislead or deceive.[24]

In Australia the 'reasonable person' test is thus already the statutory test of materiality for the insider trading and the continuous disclosure provisions. The

21 *Fortescue* (2009) 264 ALR 201, 280 [353].

22 *Australian Securities & Investments Commission v Fortescue Metals Group Ltd* [2011] FCAFC 19 ('*Fortescue Appeal*').

23 (2004) 61 IPR 420 ('*National Exchange*') (discussed below).

24 Ibid [106].

materiality enquiry is about whether a reasonable person will expect information to have a material effect on the market price of securities. It may be different to the test of whether a statement has been misleading, but there are elements in common. It focuses on the effect of the misleading statement or non-disclosure on the reasonable person's perception of market prices through buying and selling of the market as a whole.

The insider trading provision, s 1042A of the *Corporations Act 2001* (Cth), thus defines 'inside information' as 'information [that] is not generally available … [and if it] were generally available, a reasonable person would expect it to have a material effect on the price or value of [securities]'.

Section 1042D gives a further explanation of circumstances where a reasonable person would so expect. It provides that

> a reasonable person would be taken to expect information to have a material effect on the price or value of [securities] … if (and only if) the information would, or would be likely to, influence persons who commonly acquire [securities] … in deciding whether or not to acquire or dispose of the … financial products.

In other words, the reasonable person will make their conclusion of materiality on the basis of whether they think share traders (referred to as 'common investors' in the *Fortescue* case) will be influenced to buy or sell. The test then might be arguably characterised to some degree as what an ordinary investor thinks a more expert investor would do.

The continuous disclosure provisions of ss 674 and 677 of the *Corporations Act 2001* (Cth) basically mirror ss 1042A and 1042D in relation to the reasonable investor. The Griffiths Committee had recommended that the question whether information was material should be subject to the test of whether 'a reasonable person could expect it to have a material effect on the price or value of the securities issued by the company which is the subject of the information'.[25] The Griffiths Committee had considered both a reasonable person test and a percentage price formula. The latter involved a rule that any information, which would be likely to increase the price of the securities of a company by a certain percentage such as five per cent or more, would be considered material. Evidence to the committee however suggested that the securities industry considered such a test as entirely inappropriate and arbitrary.[26] Certainly such a test begs the question of what sort of evidence would establish this percentage. The most likely type of evidence would be either expert evidence by stock market professionals of their estimate of materiality (in a sense replacing the 'reasonable investor' with the 'stock market expert witness'), or expert analysis of the effect of a given later disclosure of price sensitive information and extrapolation of how this may have impacted the market if it occurred at the time of the insider trades. The Committee found that the courts were familiar with the application of the 'reasonable person' test, as it was already

25 Standing Committee on Legal and Constitutional Affairs, House of Representatives, Parliament of Australia, *Fair Shares for All: Insider Trading in Australia* (1989) [4.4.17].

26 Ibid [4.4.9].

applied in a number of other contexts. Another attraction of the test was that it was objective rather than hypothetical and removed the necessity for expert evidence.[27] The Committee noted that such a test was already applied in the US. It observed that consistency with international standards and trends was desirable in the light of the growing international reach of the world's securities markets.[28]

IV THE REASONABLE SHAREHOLDER AND MISLEADING CONDUCT — ONE OR DIVERSE SHAREHOLDERS?

In misleading conduct or non-disclosure cases it has been noted that the court will likewise need to postulate a reasonable member of the class, and in a securities non-disclosure case this may be the 'reasonable investor' or 'reasonable shareholder'[29] or 'reasonable retail investor'.[30] The person is postulated as a reasonable member of the class to ascertain whether statements to the class were misleading and deceptive conduct.

The 'reasonable shareholder' test was analysed in *Australian Securities & Investments Commission v National Exchange Pty Ltd*,[31] and on appeal in *National Exchange Pty Ltd v Australian Securities & Investments Commission*.[32] Two offers had been sent to shareholders to acquire their shares, one of which was for $2 per share. National Exchange was a company which had been occasionally identified in the press as engaging in predatory tactics such as offers to purchase shares from unsophisticated investors at less than their market value. There was evidence that the $2 offers were sent to 'issuer-sponsored' shareholders, meaning 'less sophisticated investors who do not have an established relationship with a broker' however this evidence was hearsay and was disregarded. By the $2 offers, National Exchange offered $2 for each share acquired. The offer document invited a comparison between that amount and the closing market price for the shares on 25 July 2003 ($1.93). A subsequent (and less prominent) part of the $2 offers provided that the purchase price was to be paid by 15 annual instalments payable on 3 September in each year, commencing on 3 September 2004. The Court noted that when this provision was taken into account, the actual value offered was substantially less than $2 per share.

ASIC sought declarations that the offer was misleading and deceptive and orders to restrain the sending of further offers, as well as giving shareholders the opportunity to rescind their share sales to National Exchange. The Court discussed the nature of the misleading conduct and the reasonable shareholder test and noted the dichotomy between a single reasonable shareholder and a diverse

27 Ibid [4.4.6]. Although it does not seem completely accurate to say that the test is not hypothetical given that its essence is to postulate a hypothetical person.

28 Ibid [4.4.15].

29 *National Exchange* (2004) 61 IPR 420.

30 See *King v AG Australia Holdings Ltd* [2003] FCA 955 (24 June 2003).

31 (2003) 202 ALR 24.

32 (2004) 61 IPR 420.

group to whom a representation has been made. The trial judge, Finkelstein J, had noted a possible difference in approach between that contemplated by the High Court in *Nike* and that adopted by Deane and Fitzgerald JJ in *Taco Bell.* His Honour stated:

> To a large extent this approach was approved by the High Court in *Nike International Ltd*. I say 'to a large extent' because there appears to be one area in which there is a significant difference between the views of the Full Federal Court and that of the High Court. In *Taco Co of Australia Inc* Deane and Fitzgerald JJ made it quite clear that when the impugned conduct is directed at a diverse group, that diversity must be taken into account when considering the likely effect of the conduct. It is not clear whether the High Court goes along with this approach. In *Nike International Ltd* the High Court said that, in cases where one is dealing with a representation to the public or to a section of the public, it is necessary to consider the effect of the conduct on the 'ordinary' or 'reasonable' member of the addressed section or class, and see whether he or she has been misled. For that purpose the High Court suggested (202 CLR at 85) that 'it is necessary to isolate by some criterion a representative member of that class. The inquiry thus is to be made with respect to this hypothetical individual.' No guidance is given about the selection of the criteria which this hypothetical representative will have. And it is by no means easy to determine what that criteria might be. As we are looking at the effect of conduct on the mind of the hypothetical individual, presumably the criteria must relate to the individual's capacity to understand and assimilate information. Rarely then will the sex of the individual be a consideration. On the other hand, the individual's knowledge of language, level of education, type of employment and so on are likely to be extremely important. But it is difficult to work out just how one is to go about identifying those criteria in the case of an extremely diverse group when the selection is being made for attribution to only one hypothetical individual, which is what the High Court seems to have mandated. Indeed, the mere fact that one will often be confronted with a diverse group suggests that the task is nigh on impossible.[33]

His Honour went on to say that the case before him was not concerned with conduct which is directed either to the public at large or to a section of the public because the offers were sent to 5000 identifiable shareholders. His Honour went on to state:

> ASIC's task is to establish that the offer will induce some, but not necessarily all, of those shareholders to form the mistaken belief that they were being offered cash for their shares. It is to be noted that s 1041H will be contravened if only one shareholder has been deceived. On the other hand, for the purpose of deciding whether the offer has the potential to mislead I propose (at least in this case) to act on the basis that, looking at

33 *Australian Securities & Investments Commission v National Exchange Pty Ltd* (2003) 202 ALR 24, 25 [10].

> the matter objectively, if only a few shareholders are likely to be misled that would suggest the offer is not misleading. To the contrary, it might indicate that the mistaken view is just an extreme or fanciful conclusion, which would not see the section breached: *Nike International Ltd* at CLR 86. This is not to imply that I agree with Wilcox J who in *10th Cantanae Pty Ltd v Shoshana Pty Ltd* (1987) 79 ALR 299, 302 said it was necessary to establish that a 'significant proportion' of readers must be mislead before a statement could be misleading. With respect I think that is going too far.[34]

In response to these observations Dowsett J of the Full Court noted as follows:

> I consider that this approach misconceives the respective effects of *Taco Bell* and *10th Cantanae.* In my view, the relevant passages in both cases merely express, in different forms, the test propound by the High Court in *Nike*. The way in which such a test is propounded in a particular case may, to some extent, reflect the way in which the applicant has sought to satisfy it. An applicant may seek to prove misleading effect by showing that many representees were misled. To discharge the relevant onus, it may well be necessary to show that a significant proportion was misled. On the other hand, there will be cases, such as the present case, where there is little, or perhaps no evidence that any person was actually misled. Where a regulatory authority seeks to prevent conduct in breach of a provision such as s 52 of the *TP Act* or s 1041H(1) of the Act, this will often be the case. Such an applicant will rely upon the terms of the representation and the circumstances in which it was, or is to be made, looking to the notional representative class member as the basis for assessing the likely effect of the conduct in question. To speak of a reasonable member of a class necessarily implies that one is speaking of a significant proportion of that class. It is impossible to postulate a situation in which the reasonable member of a class is not representative of such a proportion. Thus the approach adopted by Wilcox J in *10th Cantanae* is simply an alternative way of expressing the test now clearly prescribed in *Nike*.[35]

The upshot of these observations seems to be some conceptual confusion about how the 'reasonable shareholder' is to be characterised given the potential for substantial variation in the characteristics of any group of investors. It seems unclear whether the reasonable shareholder must embody the characteristics of a sizeable proportion of the class given that only one person needs to have been misled. Indeed there is authority suggesting that, as a matter of evidence, it is not necessary to call evidence from any person to say that they were misled[36] (which is consistent with the theory that the court can make its own judgment about this through the reasonable investor test). At first instance Finkelstein J's task however was to decide the matter before him rather than to resolve these difficulties, and

34 Ibid 28 [11].

35 *National Exchange* (2004) 61 IPR 420, 426 [23].

36 *Australian Securities and Investments Commission v Online Investors Advantage Inc* (2005) 194 FLR 449.

his Honour seems to have done this by noting that there were likely to be some frailties amongst the group of investors to whom the offer was directed:

> In the instant case, apart from a handful of shareholders with whom ASIC has had discussions, little is known about the shareholders save that they have a small shareholding in Onesteel. It is, however, appropriate to proceed on the assumption that the shareholders who received the offer include the educated as well as the uneducated, the thinking as well as the unthinking, the credulous as well as the cautious. Moreover, given their likely diversity, it is reasonable to act on the basis that many shareholders will not weigh each word of the offer as an educated or analytical mind might do. Nor will they necessarily subject the offer to close scrutiny.[37]

Clearly, some of the above debate may arise from the nature of proceedings by a regulator aiming to protect the anonymous 'shareholders' (not party to the proceeding) and the 'public interest' as compared with private disputes between a shareholder and a company. In any event the differing comments may be seen in a positive sense as illustrating the flexibility of the courts to modify 'reasonable investor' tests to suit the facts before them.

V OTHER CONTEXTS

The reasonable or ordinary shareholder test has been described by Santow J in *Cultus Petroleum v OMV Australia Pty Ltd*[38] in the context of takeover offers and the requirement that no material information should be omitted from a bidder's or Part A statement. Referring to older UK authority, Santow J noted that:

> A matter is material in this context if it might reasonably affect, or tend to affect the decision of the ordinary investor whether or not to accept the offer in the particular circumstances of the bid; *Cackett v Keswick* [1902] 2 Ch 456 at 464. Therefore, if a fact were omitted which, if known, would have either tended to deter offerees from accepting the bid (*Re Rossfield Group Operations Pty Ltd* (supra) at 376; (1980) 5 ACLR 237 at 241; CLC 40–710 at 33,149; *Carr Boyd Minerals Ltd v Queen Margaret Gold Mines NL* (1987) 7 ACLC 1029 at 1038, and in *Augold NL v Yaramin Pty Ltd* (1987) 5 ACLC 295 at 299) or would be likely to encourage offerees to accept the bid, that fact is material. Thus a matter is material if it 'is necessary to enable an offeree to make an informed assessment of the offer'; *Australian Consolidated Investments Ltd v Rossington Holdings Pty Ltd* (1992) 35 FCR 226; 106 ALR 221; 7 ASCR 341.[39]

The US *TSC Industries* authority was also commented on favourably by Santow J in the *Cultus* decision:

37 *National Exchange Pty Ltd v Australian Securities and Investments Commission* (2003) 202 ALR 24, 28 [12].

38 (1999) 32 ACSR 1 ('*Cultus*').

39 Ibid 11 [41].

> It has been put in the United States in relation to proxy solicitation that it is not even necessary to prove that the fact, if disclosed, would have been likely to alter an investor's decision; that it is sufficient if the omitted material would have assumed actual significance in the deliberations of reasonable offerees; *TSC Industries Inc v Northway Inc* [1976] USSC 119; (1976) 426 US 438, applied in the United States to merger negotiations in *Basic Inc v Levinson* [1988] USSC 36; (1987) 485 US 224 at 231–2. Certainly, a fact would be sufficiently material to fall within cl 17 [cl 17 of the then s 750 of the *Corporations Law*, which required information material to the making of a decision by an offeree whether or not to accept the takeover offer] if the information had a substantial bearing on the target's net worth, having regard to 'competing possibilities including offers from other sources'; see *Re Rossfield Group Operations Pty Ltd*. In deciding what information is material, the Court should not arrogate to itself the question whether those omitted facts are ones which a reasonable shareholder would consider significant, as distinct from an omitted fact which would have a significant propensity to affect the shareholder's decision. That is an argument for adopting the United States test here, though always taking into account in determining materiality the circumstances of the takeover …[40]

The reasonable shareholder test has been applied in other contexts. For example, it has been applied in relation to approvals of schemes of company arrangement. In such circumstances, it is generally accepted that a court should not approve a scheme unless satisfied that no 'reasonable shareholder' would alter his or her decision as to how to act on the scheme if the changes had been disclosed.[41] Thus, the reasonable shareholder test has been applied to schemes of arrangement in recent years by the NSW Supreme Court[42] and by the Federal Court.[43] It has also been applied by the Federal Court in relation to a share buyback,[44] and by the Takeovers Panel to letters to shareholders in the context of communications during a takeover.[45]

VI THE RELEVANCE OF MATERIALITY TO MISLEADING AND DECEPTIVE CONDUCT

Materiality through the reasonable shareholder test is an important element of insider trading, and due to the adoption of the same terminology in the continuous disclosure provisions, of a failure to make continuous disclosure. Materiality is

40 Ibid.

41 *Re Minster Assets plc* [1985] BCLC 20. See also *Re Jessel Trust Ltd* [1985] BCLC 119.

42 See *Re James Hardie Industries Ltd* [2001] NSWSC 888; *Citect Corporation Ltd* (2006) 225 ALR 137.

43 See *Michelago Limited [No 2], Re Michelago* [2006] FCA 1636 (21 November 2006); *Hardman Resources Limited, Re Hardman Resources Limited* [2006] FCA 1635 (14 November 2006); *Great Artesian Oil and Gas Limited, Re Great Artesian Oil and Gas Limited* [2008] FCA 997 (19 June 2008); *CCI Holdings Limited* [2007] FCA 832 (15 May 2007).

44 *Lion Nathan Australia Pty Ltd v Coopers Brewery Limited* (2006) 156 FCR 1.

45 *Drillsearch Energy Ltd 01* [2009] ATP 10.

not strictly part of the test for misleading and deceptive conduct, yet, because of the law on representations to the public at large as set out in *Nike*, the reasonable shareholder becomes relevant to that enquiry also. Notwithstanding this distinction, the two concepts have to some degree been conflated in some cases.

In *Fraser v NRMA Holdings Limited*,[46] the Full Court of the Federal Court (Black CJ, von Doussa and Cooper JJ), when dealing with misleading and deceptive conduct involving a prospectus, said:

> Where the contravention of s 52 allegedly involves a failure to make a full and fair disclosure of information, the applicant carries the onus of establishing how or in what manner that which was said involved error or how that which was left unsaid had the potential to mislead or deceive. Errors and omissions to have that potential must be relevant to the topic about which it is said that the respondents' conduct is likely to mislead or deceive. The need for an applicant to establish materiality is of particular importance in a case like the present one where the proposal is complex, and involves difficult questions of commercial judgment and matters of degree and conjecture as to the future about which there is room for a range of honestly and reasonably held opinions.[47]

In *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd*,[48] the Court of Appeal of the Supreme Court of NSW noted:

> The term 'material' does not form part of [the misleading and deceptive conduct provision in s 995] … and forms no part of the elements that need to be proved to establish a contravention of the section (although it will generally be the case that conduct will not be misleading or deceptive unless there is some misrepresentation or omission that is material).[49]

VII THE 'REASONABLE RETAIL INVESTOR' — A LOWER STANDARD?

Only one stock market decision makes reference to the 'reasonable retail investor' (as opposed to the 'reasonable investor' or 'reasonable shareholder'). That decision is *King v AG Australia Holdings Limited*,[50] which involved a takeover document — though the expression has been raised in the context of financial services disclosure. The financial services regime distinguishes between retail and wholesale clients with the latter being, in a general sense, people with previous experience in using financial services and investing in financial products that

46 (1995) 55 FCR 452.

47 Ibid 467–8.

48 [2008] NSWCA 206 ('*Ingot*').

49 Ibid [429].

50 [2003] FCA 652 (24 June 2003) ('*GIO*').

allows them to assess the merits, value and risks of the product or service.[51] The *GIO* stock market case was an application for leave to appeal an interlocutory decision connected with the adequacy of particulars as to why a takeover document (a 'Part B' takeover defence statement) was said to be misleading and deceptive. The case was a representative proceeding (a class action) brought on behalf of all shareholders in the company. One of the allegations made was that there had been inadequate prominence given to risk factors for the company in the Part B statement and, as a result, shareholders had rejected an offer to purchase their shares. In particular, it was alleged that the prominence of the risk factors should have been sufficient for the reasonable retail investor to have been made aware of the risk factors and their significance having regard to: (a) the amount of time that a reasonable retail investor might reasonably be expected to spend reading a Part B statement; (b) the likely level of knowledge of the reasonable retail investor of factors relevant to the GIO share price; and (c) the likely level of knowledge and education of the reasonable retail investor generally.[52] Allsop J noted:

> I read paras 8 to 11 as putting a case that there should have been either equal prominence given as set out in para 7 or such other clear annunciation of the risks elsewhere identified as to fully and fairly or adequately (I see little real difference between the two) inform the type of reader identified in *Campomar Sociedad Limitada v Nike International Limited* [2000] HCA 12; (2000) 202 CLR 45, that is, the reasonable retail investor, of the significant risk attending the choice to decide to decline the offer by identifying the significant risks attending the business of the target company.[53]

Interestingly, though there was considerable discussion in that decision about the degree of the plaintiff's onus in describing or particularising how the disclosure document could have been made 'not misleading', there was no opposition from the defendants to the concept of the 'reasonable retail investor' (as opposed to the 'reasonable investor'). This was so notwithstanding that there was no relevant statutory requirement in that case to focus on 'retail' investors as opposed to investors generally (though anecdotal evidence suggests that the company involved, GIO, did have a high number of retail or unsophisticated investors).

In the context of 'retail clients' under the financial services provisions of the *Corporations Act 2001* (Cth), Senior Member McCabe of the Administrative Appeals Tribunal gave a useful description of the reasonable retail investor in *Wright Patton Shakespeare Capital Limited v Australian Securities and Investments Commission*.[54] That decision involved administrative review of a 'stop order' that ASIC had made under s 1020E(1) of the Act in respect of

51 See *Corporations Act 2001* (Cth) ss 761G, 761GA. Note that the financial services regime also uses different nomenclature to provide protections to a 'consumer' of financial services or products whose value does not exceed $40 000, see *Australian Securities and Investments Commission Act 2001* (Cth) s12BC. This description probably overlaps at times with the retail client description.

52 *GIO* [2003] FCA 652 (24 June 2003) [21].

53 Ibid [35].

54 [2008] AATA 1068 (28 November 2008) ('*Wright*').

a Product Disclosure Statement ('PDS') in respect of a property development managed investment scheme. The Senior Member noted:

> I should say a word about the hypothetical retail client who acquires products of this kind (as opposed to products of a different kind, or products that are marketed to investors with particular identifiable qualities). The 'retail client' concept is central to the operation of s 1013D in particular [the main requirements for content of a product disclosure statement]. That person will typically be reasonably intelligent; at a minimum, the decision-maker should not assume the retail investor is obtuse, unusually stupid, or prone to behave like a 'moron in a hurry': *Morning Star Co-operative Society Ltd v Express Newspapers Ltd* (1979) FSR 113 at 117 per Foster J; see also *Re Pacific Hotels Pty Ltd v Asian Facific International Limited* [1986] FCA 297 at [28] per Spender J. While not expert in matters of finance, the retail client will exercise ordinary common sense and be reasonably diligent and reflective when deciding whether to make an investment. He or she may be less interested in technical details than regulators sometimes assume. The retail client can read what is plainly explained without drawing unlikely or off-beat conclusions. He or she has a reasonable tolerance for risk, especially where the investment opportunity in question involves financing property development. I do not suggest the individual will be incautious, but he or she is unlikely to approach a document with the lawyer's forensic eye for nuance and heightened sensitivity to risks, both real and imagined.[55]

Financial services regulation raises interesting issues in relation to reasonable shareholder tests as, in many cases, the shareholder is being assisted by a licensed financial advisor. This may raise issues about the level of sophistication to be assumed on the part of the investor, given that he or she has the benefit of such advice.

The distinction between wholesale and retail clients in the area of financial services regulation is also a theme that comes up in relation to the more specific area of listed securities regulation. The obligation to make prospectus disclosure on fund raising for instance contains exemptions for 'sophisticated investors' (in s 708(8) of the Act) and 'professional investors' (in s 708(11) of the Act). There is no similar distinction in the area of takeovers, financial reporting or share buybacks. The distinction is relevant to the reasonable shareholder issue given that disclosure exemptions for sophisticated, professional or wholesale investors tend to focus the test on the remaining less sophisticated investors, which may lead to a 'dumbing down' of the reasonable investor concept.

Likewise, there is the effect of various parts of the Corporate Law Economic Reform Programme ('CLERP') in introducing consumer protection measures from the *Trade Practices Act 1974* (Cth) into the *Australian Securities and Investments Commission Act 2001* (Cth) ('*ASIC Act*') and in particular section pt 2 div 2 which seeks to provide additional protections for 'consumers' of financial

55 Ibid [15].

services. These are defined by s 12BC of the *ASIC Act* as consumers of services priced at $40 000 or less.[56]

The recognition of at least two 'types' of investors in the market also raises the possibility of a bifurcation of the test so that there could be, depending upon the circumstances, a reasonable retail investor and a reasonable sophisticated investor test in the market (and possibly an ordinary reasonable investor in the middle).

Though not stated in the decision as such, it is arguable that the test applied in *National Exchange* was a test focused on less sophisticated investors. There was evidence that the $2 offers were sent to 'issuer-sponsored' shareholders, meaning 'less sophisticated investors who do not have an established relationship with a broker',[57] however this evidence was hearsay and was disregarded. Nevertheless, the standard of sophistication applied to the investors does seem to be fairly low so that there is a strong 'consumer protection' aspect to the decision. In this sense, it may not be a decision about reasonable shareholders as reasonable *retail* shareholders.

It is submitted that the 'reasonable *retail* investor' test should exist and imply a lower standard of sophistication of investors and should be applied by courts, where it is clear that the class of investors is heavily weighted toward retail or unsophisticated investors. The differentiation also raises issues about the debate between more disclosure and better or more intelligible disclosure. It seems likely that less sophisticated investors will benefit marginally, if at all, by a high volume of disclosure (at least beyond a certain point) whereas the aim of more intelligible disclosure seems quite likely to be of greater assistance to them. Highly sophisticated investors by contrast may benefit to some degree from greater volumes of disclosure, assuming that they have time to process it; although even here, better disclosure will probably win out (assuming that 'better' means more relevant).

VIII THE 'REASONABLE INVESTOR' IN THE UNITED STATES

In the US it has been stated that

> what a 'reasonable investor' would under all the circumstances expect, is a matter for determination by the trier of fact in much the same manner as the determination of what a reasonable person would or would not have done concerning acts claimed to have been negligent.[58]

Thus the 'reasonable investor' is closely analogous to the 'reasonable person' of negligence law.

56 Introduced by *Financial Services Reform (Consequential Provisions) Act 2001* (Cth).

57 *National Exchange* (2004) 61 IPR 420, 422 [2].

58 *Piambino v Bailey*, 610 F 2d 1306, 1320 (5th Cir, 1980).

Some guidance on who the reasonable investor is has been provided in the US in the context of contingent or speculative information. The US Supreme Court has adopted an approach of the Second Circuit's in *SEC v Texas Gulf Sulphur Co*,[59] known as the probability/magnitude approach. It states that 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.'[60] In the same opinion (which was cited by the US Supreme Court in *Basic Inc v Levinson*),[61] the Second Circuit stated that:

> The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders. Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.[62]

In the US the putative reasonable investor has also been variously described in assorted cases (as identified by Epling and Thompson)[63] as the 'average reasonable investor',[64] the 'prototype reasonable investor',[65] the 'reasonable potential investor',[66] the 'proverbial reasonable investor',[67] the 'average investor',[68] the 'lay investor',[69] the 'typical investor',[70] the 'ordinary prudent investor',[71]

59 401 F 2d 833 (2d Cir, 1968).

60 Ibid 849.

61 485 US 224, 238 (1988).

62 *SEC v Texas Gulf Sulphur Co*, 401 F 2d 833, 849 (2d Cir, 1968).

63 Richard L Epling and Terence W Thompson, 'Securities Disclosure in Bankruptcy' (1983–84) 39 *Business Lawyer* 855.

64 *Dower v Mosser Industries*, 648 F 2d 183, 187 (3rd Cir, 1981) (reference to certain information as being 'of dubious value to the average reasonable investor in determining the worth of his stock').

65 *Dura-Bilt Co v Chase Manhattan Bank*, 89 FRD 87, 94–6 (SD NY, 1981) (materiality test is concerned only with whether a prototype reasonable investor would have relied).

66 *Alna Capital Associates v Wagner* 532 F Supp 591, 599–600 (SD Fla, 1982) (evidence regarding importance of certain facts to 'reasonable' potential investors).

67 *Mills v Esmark Inc*, 544 F Supp 1275, 1294 (ND Ill, 1982) (assumption that the 'proverbial "reasonable shareholder" would understand' the meaning of a particular term).

68 *Shores v Sklar*, 647 F 2d 462 (5th Cir, 1981) (average investor in industrial revenue bonds would have had indication of situation); *Natural Resources Defense Council v SEC*, 606 F 2d 1031, 1040 (DC Cir 1978) (additional information would confuse or mislead the 'average investor').

69 *Van Gemert v Boeing Co*, 520 F 2d 1373, 1378 (2nd Cir, 1975) (average lay investor unlikely to notice certain published financial information).

70 *Broad v Rockwell International Co*, 642 F 2d 929, 939 (5th Cir, 1981) (primary concern of the typical investor in a long-term debt security); *United Gas Pipe Line Co v Federal Energy Regulatory Commission*, 618 F 2d 1127, 1137 (5th Cir, 1980) (situation must be viewed as it appeared to a typical investor).

71 *SEC v Arthur Young & Co*, 590 F 2d 785, 787 (9th Cir, 1979) (reference to SEC oral argument with respect to 'ordinary prudent investor'); *SEC v American Realty Trust*, 429 F Supp 1148, 1156 (ED Va 1977) ('An average investor, ie, a reasonably prudent investor, would not be misled by such subtle variations in terminology').

the 'intelligent investor',[72] the 'typical rational investor',[73] and the 'reasonably cautious investor'.[74]

Huang, arguing partly from a behavioural approach (see below), has commented that many courts appear to view the reasonable investor as referring to a normative idealised type of behaviour, instead of a descriptive realistic depiction of actual behaviour.[75] He then questions whether the practice of courts continuing to utilise such a definition of reasonable investor and the related standard of materiality is relevant or appropriate. Discussing the emotional or 'moody' factors involved in investing, he notes that courts have not eliminated and will not even necessarily reduce moody investing simply by holding that moody investing behaviour is not reasonable, especially if moody investing is prevalent and unconscious. He states that the issue is relevant to the US 'puffery' defence where companies argue that some statements are mere puff and should not be relied upon. He argues that 'puffery' can affect an investor's mood and that therefore it may be reasonable for reasonable investors to rely on 'puffery'.[76]

A *The Reasonable Investor Test, Causation of Loss in Class Actions and* Basic v Levinson

In *Basic Inc v Levinson,*[77] the US Supreme Court expressly adopted the reasonable investor test. It stated:

> The Court also explicitly has defined a standard of materiality under the securities laws, see *TSC Industries, Inc v Northway, Inc*, 426 US 438 (1976), concluding in the proxy-solicitation context that 'an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.' *Id*, at 449. Acknowledging that certain information concerning corporate developments could well be of 'dubious significance,' *id*, at 448, the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management 'simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decisionmaking.' *Id*, at 448–449. It further explained that to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the

72 *Holmes v Bateson*, 583 F 2d 542, 554 (1st Cir, 1978) (disclosure of data required by an 'intelligent investor-stockholder'); *Luther v Loewi & Co*, 549 F 2d 1173, 1177 (8th Cir, 1977) ('highly unlikely that an intelligent investor would make such a stupid arrangement with his broker') (Ross J).

73 *Kolb v Chrysler Co*, 661 F 2d 1137, 1144 (7th Cir, 1981) (actions of a 'rational investor'); *Green v Occidental Petroleum Co*, 541 F 2d 1335 (9th Cir, 1976) (purchases of a typical rational investor).

74 *SEC v Seaboard Co*, 677 F 2d 1297, 1306 (9th Cir, 1982) (reaction of a reasonably cautious investor).

75 Peter H Huang, 'Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors' (2005) 13 *Supreme Court Economic Review* 99, 111.

76 Ibid 128.

77 485 US 224 (1988).

> reasonable investor as having significantly altered the "total mix" of information made available.' *Id*, at 449. We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.[78]

Somewhat ironically, the same decision also gave support to the 'fraud on the market' theory of causation in a securities class action where individual reliance of particular plaintiffs on the misleading statements or non-disclosures is dispensed with. In the words of the Court:

> Requiring a plaintiff to show a speculative state of facts, ie, how he would have acted if omitted material information had been disclosed, see *Affiliated Ute Citizens* v *United States*, 406 US, at 153–154, or if the misrepresentation had not been made, see *Sharp* v *Coopers & Lybrand*, 649 F 2d 175, 188 (CA3 1981), cert denied, 455 US 938 (1982), would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market. Cf *Mills* v *Electric Auto-Lite Co*, 396 US, at 385.[79]

Thus, having established the reasonable investor as the standard for when representations were material, the Court dispensed with the individual investor on the question of whether representations had actually directly affected an individual plaintiff. What was seemingly substituted however was the question of whether material representations had affected the market price as this became the basis for calculating loss (ie whether the plaintiff had purchased shares at a price artificially inflated by non-disclosures of negative information or sold at a price artificially reduced by non-disclosures of positive information). In so doing however, the Court impliedly accepted that the effect of misrepresentations on 'the market' itself was a relevant question.

IX IS 'THE MARKET' EQUIVALENT TO 'THE REASONABLE INVESTOR'?

There is a temptation to equate the 'reasonable investor' with the 'market' in the sense of expecting that what is material to the reasonable investor will be material to the market and vice-versa. An example of this kind of analysis is contained in the following statement in *Riley v Jubilee Mines NL*.[80] After adopting the reasonable investor test from the US decision in *TSC Industries*, Master Sanderson noted:

> Applying that test, I am satisfied that a reasonable person would expect the information to have a material effect. This was good news. It provided a junior explorer with information about a tenement that was sufficient to interest a major mining house. Certainly, the defendant was focused on gold exploration but that was not to the exclusion of everything else.

78 Ibid 232.

79 Ibid 245.

80 *Riley v Jubilee Mines NL* (2006) 59 ACSR 252.

> Again, by reference to the effect on the share price of the 11 June 1996 announcement, it can be seen that the expectations of the reasonable person were proved right.[81]

The logic seems to be that the reasonable investor's expectations should ultimately align with the market's judgment if they are to be considered 'reasonable'. As has already been noted, Australian courts have more recently resisted this temptation with their acceptance that it is the *ex ante* reasonable investor test which is to be preferred over the *ex post* test of what the stock market actually did on later release of corrective or other disclosure.[82]

In the US an example of the conflation of the reasonable investor with the market is contained in the following statement of the Third Circuit in *In re Burlington Coat Factory*:

> Ordinarily, the law defines 'material' information as information that would be important to a reasonable investor in making his or her investment decision. In the context of an 'efficient' market, the concept of materiality translates into information that alters the price of the firm's stock … This is so because efficient markets are those in which information important to reasonable investors (in effect, the market …) is immediately incorporated into stock prices.[83]

Fischel argues by contrast that the market and the reasonable investor are quite different and that conventional enquiry into materiality — whether the misinformation or omission was material to the reasonable investor's decision to buy or sell the securities — should be modified.[84] The materiality enquiry, he argues, should be an enquiry into whether the information actually did cause the security to trade at an artificially high or low price, rather than whether the information would be material to the 'reasonable investor'.[85] Fischel criticises the 'reasonable investor' standard as containing 'no tools for resolving the materiality problem' apart from an 'I know it when I see it' test.[86] He argues that this lack of precision leads to a danger that a piece of information may appear to be important and material to investors when in fact it was not.[87] This could occur where the misinformation lacked credibility so that the market in fact had no regard to it (ie the market was not misled).[88] Likewise, an omission to state facts may seem to be material but, because the information was available from other sources, the

81 Ibid 312 [290].

82 *Fortescue* (2009) 264 ALR 201, 301 [474].

83 114 F 3d 1410, 1425 (3rd Cir, 1997). A similar approach was recently argued for in Canadian courts. In *Nguyen v CP Ships Ltd*, 2008 QCCS 3817, [34]–[35], [37] Barakett J stated that '[t]he key issue is not finding out whether or not an individual has been duped, but rather if the public, as a whole, (the market) was duped by public information that influenced the price on the stock market.'

84 Daniel R Fischel, 'Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities' (1982) 38 *Business Lawyer* 1, 6–7.

85 Ibid 5–7.

86 Ibid 6.

87 Ibid.

88 Ibid.

market may not in fact be deceived.[89] Thus, Fischel argues that it is a contradiction for a statement to be material yet not affect enough traders to influence the market price. The meaning of materiality under the market model, therefore, should be that there had to be an effect on the market price.[90]

The conflation of the reasonable investor with 'the market' was not accepted by the US Supreme Court in *Basic Inc v Levinson*,[91] however, which continued to rely on the 'reasonable investor'. Thus the Supreme Court objects to the 'market test' as it is a 'bright line' test and prefers to look at each matter on its relevant facts. An example of this sort of logic is set out the Ninth Circuit decision of *No 84 Employer-Teamster Joint Council Pension Trust v America West Holding Co*:[92]

> In *Basic*, the Supreme Court expressly adopted the 'reasonable investor' standard set forth in *TSC Industries* for determining materiality in the Section 10(b) and Rule 10b-5 context. … Pursuant to *Basic*, we reject Defendants' argument for adoption of a bright-line rule requiring an immediate market reaction. The market is subject to distortions that prevent the ideal of 'a free and open public market' from occurring … As recognized by the Supreme Court, these distortions may not be corrected immediately … Because of these distortions, adoption of a bright-line rule assuming that the stock price will instantly react would fail to address the realities of the market. Thus, we decline to adopt a bright-line rule, and, instead, engage in the 'fact-specific inquiry' set forth in *Basic*.[93]

It is submitted however that 'the market' and the 'reasonable investor' remain as two different entities and should not be confused. The implications of the Efficient Capital Markets Hypothesis ('ECMH')[94] make this distinction doubly clear, especially with sophisticated information. In theory it will be possible for highly material information to be buried amongst other data or its importance not adequately highlighted by a company. The latter may be deliberate, inadvertent but negligent or indeed inadvertent but without negligence. In any case the importance of the information may be picked up by a sophisticated external analyst but not by the average reasonable investor. If picked up by enough such expert investors on the buying and selling side it is possible that the information will move the market price, notwithstanding the lack of appreciation of its significance by reasonable investors. This is an application of the ECMH. In practical terms it may work as follows: suppose for example that very good news is received but only a few experts comprehend same. Those experts will start to buy and tend to bid the price up by the increased volumes of their buying activity. Assuming some experts are already holders of the shares these will also tend to push the price up as they hold out for considerably higher prices and therefore

89 Ibid 7.

90 Ibid 11.

91 485 US 224 (1988).

92 320 F 3d 920 (9th Cir, 2003).

93 Ibid 934.

94 See Eugene F Fama et al, 'The Adjustment of Stock Prices to New Information' (1969) 10 *International Economic Review* 11.

constrict supply in having lower volumes for sale at the lower prices. It is by no means clear however that the reasonable shareholder will have been moved unless the good news was reasonably clear to that (fictional) person on its face. We thus see that 'the market' and the reasonable retail investor may be different animals and that 'the market' may indeed be more astute than the reasonable retail investor. This is not to say that some players in the market will not have been deceived and will not have suffered loss however so that in that sense the reasonable investor test may be more protective of investors.

The issue was also recently touched upon in Ireland in a civil liability claim in relation to insider trading (the Irish jurisdiction is here invoked due to the relevance of the issues in the case and the similarity to Fischel's argument rather than its authority in Australia which is admittedly limited).[95] The claim was brought by the issuer of the securities, Fyffes, against DCC and companies associated with Mr Flavin. Mr Flavin was a director of Fyffes and had traded on the basis of confidential management trading reports from late 1999. Sales by Mr Flavin as agent for DCC took place in February 2000 at the height of the dot com speculative boom. There was no dispute between the parties that the information in the trading reports was not generally available, however, there was a dispute as to the materiality or price sensitivity of the information. In the Irish High Court at first instance Laffoy J considered the price sensitivity test in s 108 of the *Companies Act 1990* (IE) and purported to develop a 'reasonable investor' test of price sensitivity on the basis of case law.[96] This case law included the US authority of *TSC Industries*. Laffoy J posed the question of whether the reasonable investor would conclude that the information in the confidential trading reports would 'in the context of the total mix of information available … probably impact on Fyffes' share price to a substantial or significant degree'.[97] This test was applied, as opposed to looking at what the market reaction actually was when the confidential information was eventually released. The result was that Laffoy J concluded that the information was not in fact price sensitive so that the insider trading case failed.

Fyffes appealed this decision to the Supreme Court of Ireland. In the Supreme Court Denham J noted that the only issue to be considered was price sensitivity but that Laffoy J had attempted to determine that issue by reference to a 'reasonable investor' that found no support in the authorities nor was it referred to in the statute. It was found by Denham J to be inconsistent with what the Court was required to do under the statute.[98] In relation to the reasonable investor Denham J said as follows:

> I do not find this to be an appropriate or useful legal tool. There is no reference to the 'reasonable investor' in s108(i), or indeed anywhere in the Act of 1990. Nor may it be implied from the *Council Directive*. It

95 See generally Josephine Coffey, 'The Reasonable Investor Test across Two Continents' (2008) 1 *Journal of the Australasian Law Teachers Association* 45.

96 *Fyffes plc v DCC plc* [2007] IESC 36, [7(ii)] ('*Fyffes*').

97 Ibid [22].

98 Ibid [7(ii)].

> is a method of interpretation which removes the analysis required one step from the law as stated. It creates a system where the law is being looked at through the eyes of a notional person and it renders the situation opaque. It is not a legal principle appropriate to the section. Indeed, as it is not expressly or impliedly in the section there would be a danger of legislating on the issue if this test were applied. In addition, there are a myriad of factors and investors in a market, and to choose some or either as representative of a reasonable investor appears subjective and arbitrary. The issue is the effect on the share price in the market of the information if the information were generally available.[99]

The trial judge had excluded evidence as to market reaction to a corrective statement on 20 March 2000 on the basis that it was irrelevant. Denham J found that the March statement was relevant and admissible as illustrating the effect on the share price of the release of information very similar to that in the confidential November and December 1999 Trading Reports.[100] Thus the Court found that the relevant test was as follows:

> The test, as set out clearly in s 108(1), is an objective test. Was there information? Was it generally available? If it was made generally available, would it be likely to materially affect the price of the shares on the market? The answer is equally clear. There was information. It was not generally available. It was bad news, it was information of a risk, it would concern the market. It was information likely to affect the price of the shares on the market. In considering the information it is not appropriate to offset that with information already in the market. The use of comparators is helpful. In this case there was a comparator in the 20th March, 2000 Announcement, which contained similar information. The 20th March Announcement, being a useful comparator, illustrated the effect on the market of similar information — which was price-sensitive, there was a significant drop in the share price.[101]

The result was that the High Court decision was overruled. The Supreme Court found that the information was material and price sensitive.

The approach of the Supreme Court comes close to Fischel's argument for looking at the effect on 'the market' rather than the 'reasonable investor' and it can be criticised. It appears to be heavily reliant on evidence of how the market actually responded to corrective disclosure. This can be problematic for a number of reasons. Firstly, and adopting the Court's own words, there are a 'myriad of factors' at work in the market and looking at the market's later reaction to similar but not identical information cannot necessarily be said to be firm evidence of the likely effect or materiality of particular information at a particular earlier time.[102] Though it is conceivable that 'event study' evidence might be submitted

99 Ibid [22].

100 Ibid [28]

101 Ibid [31].

102 Ibid [22].

to attempt to isolate the effect of particular information from other factors in the market, this is not a simple task.[103] This approach also appears to rob the court of flexibility in dealing with particular information and its likely effect. It may have the unintended effect of removing much of the court's jurisdiction as a trier of fact and replacing it with the need for considerable expert evidence. Thus, if the court cannot draw conclusions as to the view of the reasonable investor it might be stuck with having to assess large amounts of expert evidence about how the market was actually affected by particular information together with attempts to isolate partial movements caused by particular pieces of information. It also clearly has the effect of hindsight bias as the present effect of information is judged or determined by its later actual effect. There is also the effect of leakage and 'anticipation' by the market which can result in understated results from the release of information. This can occur when the contents of a confidential report slowly leak out into the market with a gradual effect on the share price so that when it is actually released there is no effect on the share price at all — notwithstanding that the information is in fact price sensitive.

X WHAT IS THE EFFECT OF BEHAVIOURAL LAW AND ECONOMICS UPON THE REASONABLE INVESTOR TEST?

The concept of the reasonable investor as developed in US law and partly adopted in Australia is based partly upon an implicit assumption that that actor will act rationally.[104] Though the test is strictly that the reasonable investor acts 'reasonably', this has been at least partly interpreted to mean that the reasonable investor is also rational in the economic sense.[105] The concept of reasonableness is said to be partly objective in meeting societal expectations whilst also subjective in remaining true to a subjective understanding of legal rights and duties.[106] As has been noted, in Australia, the reasonable person is said to be of ordinary prudence, utilising ordinary care and skill and a hypothetical person. The concept is not completely objective as there is also a subjective element in the test. This is partly provided by looking at the particular circumstances in which the person finds him or herself.[107]

Thus any discussion of the reasonable person cannot neglect to mention the expanding field of behavioural finance ('BF') and behavioural law and economics ('BLE') which note exceptions to rationality in the normal behaviour of stock

103 An event study is a statistical analysis that isolates the effects of an event on a security's price and measures the likelihood that the effect could have been due to the normal random fluctuations of the security's price as opposed to being due to a particular event. See A Craig Mackinlay, 'Event Studies in Economics and Finance' (1997) 35 *Journal of Economic Literature* 13, 13, cited in Frederick C Dunbar and Dana Heller, 'Fraud on the Market Meets Behavioral Finance' (2006) 31 *Delaware Journal of Corporate Law* 455, 468.

104 See generally David A Hoffman, 'The "Duty" to be a Rational Shareholder' (2005–06) 90 *Minnesota Law Review* 537, 578.

105 *Chock Full O'Nuts Co v Finkelstein*, 548 F Supp 212, 219 (SD NY 1982).

106 Hoffman, above n 104, 540, quoting Dan B Dobbs, *The Law of Torts* (West Group, 2000) §§ 117, 118.

107 Rosalie P Balkin and J L R Davis, *Law of Torts* (Butterworths, 2nd ed, 1996) 266.

market players. In terms of the reasonable investor analysis, this raises the question of how far the reasonable investor's behaviour may still be considered reasonable when it may not be entirely rational. Implicit in the critique is the difficulty in knowing what exactly is 'rational' and the dangers of hindsight bias in making this evaluation. Nevertheless the discipline of BF has provided some useful insights into the behaviour of the stock market in recent times.

It is said that behavioural law and finance starts from the observation that financial markets are dominated by people rather than automatons or computer programs and that this makes a difference to the way the financial world operates.[108] BF suggests that investors may not always accurately perceive underlying business values because investor sentiment, rather than rational economic calculation, plays a large part in trading.[109] It further asserts that even those investors who do accurately perceive underlying business values will not always act to offset the sentiments of those who do not because they face risks too great for such an undertaking. As a result pricing in stock markets does not always equate to value.[110]

The literature on the behaviour of individual investors focuses on evidence said to show systematic deviations from rationality. Some examples of such deviations from rationality include:

(a) Overconfidence. Rational investors should revise their beliefs in a correct manner in light of new information, however there is evidence that people tend to overestimate the precision and value of their knowledge.[111] Associated with this is a tendency to take credit for gains and blame bad luck for losses. It is suggested also that experts have more overconfidence than unsophisticated or inexperienced investors,[112] when in fact it might have been expected that they would have a more realistic view of their own potential accuracy. The finding also suggests that institutional investors are not so likely to bring mispriced stocks back 'into line'.[113]

(b) Overreaction. It has been noted that markets frequently react quickly but excessively to new information, with stock prices moving to levels that are either too high or too low and which eventually revert to a more reasonable level.[114] This occurs particularly when

108 Richard H Thaler (ed), *Advances in Behavioral Finance* (Russell Sage Foundation, 1993) vol 1.

109 Lawrence A Cunningham, 'Behavioral Finance and Investor Governance' (2002) 59 *Washington and Lee Law Review* 767, 769.

110 Ibid.

111 Dunbar and Heller, above n 103, 489.

112 Marc Albert and Howard Raiffa, 'A Progress Report on the Training of Probability Assessors' in Daniel Kahneman et al (eds), *Judgment under Uncertainty: Heuristics and Biases* (1982) 492, referred to in ibid 490.

113 Ibid.

114 Donald C Langevoort, 'Theories, Assumptions in Securities Market Regulation: Market Efficiency Revisited' (1992) 140 *University of Pennsylvania Law Review* 755. See also Werner F M De Bondt and Richard H Thaler, 'Does the Stock Market Overreact?' in Richard H Thaler (ed), *Advances in Behavioral Finance* (Sage Russell Foundation, 1993) vol 1, 249.

the information is unexpected and dramatic.[115] On the other hand 'cognitive conservatism' or under-reaction has also been noted where there is an unwillingness of investors to change their views even where there is accumulating evidence to the contrary. This is particularly so if the evidence is undramatic.[116]

(c) Investors selling 'winning' stocks too early and holding onto losing stocks too long.[117] This is because they prefer a sure gain to taking a gamble. Similarly they will prefer taking a gamble to a sure loss.[118]

(d) Fashion. There is sometimes a tendency to make decisions based on the most recent or easily recalled information or information that may reflect a current fashion or fad rather than on a more comprehensive set of data. There is also a tendency to extrapolate from recently observed trends when there is in fact no trend or sequence in existence.[119]

(e) Ignoring of catastrophic risks. It has been observed that investors tend to ignore large or catastrophic risk that has a low chance of occurring because of over optimism and an inability to comprehend and evaluate such risk.[120]

(f) Gambler's mentality. It is possible that a sizable number of people invest in order to 'play' the market and thus exhibit the biases of gamblers rather than cautious investors.[121]

(g) Noise. 'Noise' is to be contrasted with information.[122] It is said that people sometimes trade on noise rather than on information. Noise has many forms including hype, inaccurate ideas, inaccurate data or information that has not arrived yet. Noise allows speculative trading to occur and is indicative of market inefficiency.[123] Not all trading is for the purpose of realising a capital gain. Some investors may liquidate some or all of their portfolio for the purpose of purchasing a house or similar non-market related event. Hedge funds and others may also trade with a view to reducing risk exposure or some other objective. Where there is a lot of such trading there is 'noise' which may result in false trend signals as prices move suddenly up and then down again.

115 De Bondt and Thaler, above n 114, 263.

116 Entcho Raykovski, 'Continuous Disclosure: Has Regulation Enhanced the Australian Securities Market?' (2004) 30(2) *Monash University Law Review* 269, 272.

117 Hersh M Shefrin and Meir Statman, 'The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence' in Richard H Thaler (ed), *Advances in Behavioral Finance* (1993) vol 1, 507. See also Terrance Odean, 'Are Investors Reluctant to Realize Their Losses?' (1998) 53 *The Journal of Finance* 1775, referred to in Dunbar and Heller, above n 103, 485.

118 Dunbar and Heller, above n 103, 489.

119 Langevoort, 'Theories, Assumptions in Securities Market Regulation', above n 114, 859.

120 Ibid.

121 Ibid 868.

122 Fischer Black, 'Noise' in Richard H Thaler (ed), *Advances in Behavioral Finance* (Sage Russell Foundation, 1993), vol 1, 3–9.

123 Ibid.

> Further, and related to this problem, is the existence of cognitive and psychological errors such as overconfidence in bull markets,[124] and fear in bear markets. Noise creates a series of problems for market theory in relation to a number of its assumptions:
>
> i. It distorts the ECMH in that share prices movements may not all be based upon changes in information available to the market.
>
> ii. It dilutes the linkages between changes in information and share price movements.
>
> iii. It distorts calculation of losses so that forcing corporations to pay damages based on noisy disclosures may have perverse effects, including discouraging disclosure.[125]

Finally, it has been argued that rational traders can create a price that does not reflect the underlying value of the company because it is rational to overpay for stock where an investor believes that they can recoup the overpayment by selling on to someone else at an even greater price. This is known as the theory of rational bubbles.[126] Under this theory an investor may pay $12 for a stock that is worth $10 because there is a 50 per cent likelihood that the stock will go up to $14 and a 50 per cent likelihood that the bubble will burst and the stock will go down to $10. The point is that the true value of the stock is closer to $10 however the existence of the bubble makes overconfidence in the stock rational (until the bubble bursts of course). Market theory would normally suggest that irrational behaviour is quickly corrected by the contrary behaviour of rational investors, however in circumstances of a bubble or herd behaviour, such arbitrage does not occur because it is too risky for the rational investor to take a contrary position when it is too uncertain if (or more correctly when) the irrational state of the market will be corrected (thus in the words of J M Keynes: 'nothing is more suicidal than a rational investment policy in an irrational world'[127]).[128] Thus, in a rational bubble the stock price will not reflect the fundamental value of the company and in that sense the ECMH will not hold true.

From a BLE perspective Huang argues that much investing is 'moody investing', by which he means investment decisions that are at least partly non-cognitive. This rejects the traditional financial view of unbounded rationality in favour of bounded rationality based upon evidence that humans use both valuation by

124 See Robert J Shiller, *Irrational Exuberance* (Princeton University Press, 2nd ed, 2005).

125 Larry E Ribstein, 'Fraud on a Noisy Market' (Working Paper No LE05-022, Illinois Law and Economics Working Papers Series, University of Illinois College of Law, 3 August 2006) 3.

126 Olivier J Blanchard and Mark W Watson, 'Bubbles, Rational Expectations and Financial Markets' (Working Paper No 945, National Bureau of Economic Research, 1982), referred to in Dunbar and Heller above n 103, 491.

127 Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States 1867–1960* (Princeton University Press, 1963) 810.

128 D C Langevoort, 'Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation' (2002) 97 *Northwestern University Law Review* 135, 148.

calculation as well as valuation by feelings or experience.[129] The result, he argues, is that the US Supreme Court needs to rethink its answers to what it means to be a reasonable investor. He argues that the *TSC Industries* test of a reasonable investor effectively describes an intelligent speculator who cognitively evaluates and calculates securities risks as opposed to reacting moodily and perhaps unconsciously to such risks.[130] It is said that courts will not eliminate such moody investing simply by holding that such behaviour is not 'reasonable'. Rather it is suggested that the reasonable investor model can be utilised figuratively rather than just literally and that it should not privilege cognition over so called 'affect' (being the effect of the way information is presented to the investor and how this 'affects' such investor).[131] Another aspect to such a 'moody' interpretation is that materiality could be reformulated so that an 'emotionally vivid' presentation of information is more likely to be material than a less 'emotionally vivid' presentation.

The resulting perspective seems to be 'pro-shareholder'.[132] This view is also seen in a criticism of the rational (though not perhaps 'reasonable') shareholder conception by Hoffman. He states that:

> Courts require investors to investigate their purchases, to coldly process risk, to disregard oral statements of optimism and in general to be economically rational. If investors fail to meet these expectations, judges deny them the protection of the securities laws.[133]

This statement may understate the flexibility of courts in conceptualising a reasonable shareholder, at least in the Australian context, but it might be a fair statement of what a rational shareholder might be expected to be (if that were the test). Hoffman's research suggests that US courts dismiss some 50 per cent of private securities claims on the grounds of alleged non-disclosures not being material to the reasonable investor. This 'presumed immateriality' is said to result from a 'normative judicial commitment distinguishing between investor behavior entitled to protection from securities fraud and behavior which is not.'[134] Hoffman asserts evidence that courts implicitly (and sometimes explicitly)[135]

129 Huang, above n 75. Bounded self interest is a component of BLE research which attempts to go beyond narrow self interest and narrowly rational self interest to explain the attractiveness of norms of fairness, sharing, reciprocity and altruism in ways distinct from those traditionally relied upon by economists. See Hoffman, above n 104, 546.

130 Huang, above n 75, 111.

131 Ibid.

132 The Behavioural Law and Economics School has been seen as politically liberal as its distrust of the perfect efficiency of markets sometimes encourages government intervention. See Hoffman, above n 104, 546. See also Stephen M Bainbridge, 'Mandatory Disclosure: A Behavioral Analysis' (1999–2000) 68 *University of Cincinnati Law Review* 1023, 1058.

133 Hoffman, above n 104, 538.

134 Ibid 542.

135 In *Chock Full O'Nuts Corp v Finkelstein*, 548 F Supp 212, 219 (SD NY, 1982) the Court noted: 'In evaluating disclosure, as we must here, we continue to assume rationality and that all participants approach the situation thinking as Economic Man, within Adam Smith's definition seeking to follow the lead of Smith's "invisible hand"'.

equate investors' reasonableness with economic rationality and irrationality as unreasonableness. He describes this as an ideological choice.[136]

Ironically (from an ideological point of view) the argument that shareholders are not like this may be a criticism of the type of shareholders which the ECMH assumes to exist. This is ironic because the ECMH grounds the 'fraud on the market' theory which has facilitated securities class actions by shareholders, has been seen as sympathetic to shareholders (and the Plaintiff bar)[137] and is more associated with the liberal side of ideological debate in facilitating litigation for trial lawyers.[138]

The BLE perspective is certainly useful in questioning the pure rationality of the reasonable investor however it cannot be expected that the courts will jettison some expectation of rationality by that entity. Where the analysis may be useful however will be in situations where there are differential types of investors from the sophisticated to the less sophisticated, or indeed different types of situations where investors may be expected to act less rationally (a bubble market for instance). The courts can in such situations take some judicial notice of variations in types of investors and situations confronting investors and hopefully adopt a flexible approach to the characteristics of the 'reasonable investor' that they may imply. This appears to be a case of the court being left with flexibility to do this as the justice of the case before it demands.

XI CONCLUSION

The 'reasonable investor' test has appeared in Australian and overseas case law in a variety of garbs and for a variety of purposes, though generally to test the effectiveness of stock market disclosure. It is a 'reasonable person' test typically utilised for the purpose of judging conduct objectively though with some subjective expertise or knowledge (that of a shareholder). It has been utilised in assessing whether conduct or representations would mislead shareholders (the misleading conduct enquiry) and also whether conduct or representations would cause a shareholder to expect that other shareholders would buy, sell, hold or otherwise deal shares on the basis of those representations (the materiality enquiry). The reasonable shareholder test is to be distinguished from a market test and is in the writer's view, to be preferred to the market test due to its having greater flexibility (with courts being able to modify the conception of the reasonable investor to suit the factual situation and types of investors who may be involved in the facts before the court). The reasonable investor test may even on occasion be bifurcated between sophisticated or institutional or wholesale investors and 'retail' or less sophisticated investors. This happens in relation to prospectus disclosure in

136 Hoffman, above n 104, 543.

137 See, eg, Barbara Black, 'Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions' (1983–84) 62 *North Carolina Law Review* 435.

138 See, eg, Leslie Wayne, 'Trial Lawyers Pour Money into Democrats' Chests', *The New York Times*, 23 March 2000.

Australia, in relation to the consumer protection provisions of the *ASIC Act* and in some limited case law. Perhaps related to the last point is the perspective of the school of BLE which asserts that the reasonable shareholder may not be the same as the completely economically rational shareholder. This insight again leads to the conclusion that courts should have the flexibility to postulate a reasonable investor based upon the facts and persons before them rather than on a narrow preordained basis (nor according to the movements of a market that tends to be led by the sophisticated investors).