

ANTI-FRAUD DILEMMA: DEFINING MATERIALITY

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Materiality is one of the more important and oft-used concepts in interpreting the requirements of the federal securities laws. Yet the term has never been definitively defined by the administrator of those laws, the Securities and Exchange Commission. This is as it should be in the eyes of this commentator.

Nevertheless, the clamor for certainty through an SEC administrative definition of the term “material” never ceases. Though the Grand Inquisitor may have been correct in noting in while administering his charge that at some point there must be certainty, that necessity may not exist in this area. In the securities area, the search for certainty is rather like the quest for the holy grail. It is the quest itself however, that continually modifies and refines the concept and therefore the definition of materiality. It is the common law development of securities law interpretations at its best. It is a practical recognition that materiality can differ over time and circumstance.

A hard and fast definition would require courts and administrators to find new tools to accomplish the purposes of the securities laws in this area and the fulfillment of the overall objective of those laws, namely the protection of investors and the stimulation of efficient, free and fair markets. Such a development would, at least in the short run, lead to a greater uncertainty than now exists in this area. The purpose of this article is to explore the development of the meaning of materiality, to place it in its various contexts within the securities law scheme and finally to attempt the impossible job of offering a contemporary working definition of the oft-damned term.

The proposal by the SEC to adopt Regulation FD in December 1999² was the occasion for renewed demands for a definition of materiality. Regulation FD regulates the dissemination of material nonpublic information.³ An earlier SEC enforcement case, Dirks v. SEC,⁴ created the requirement for a showing of breach of fiduciary duty as a predicate to establishment of a violation of Rule 10(b)(5).⁵ Although the SEC had some success in cases in which the tipper of the information did not trade or benefit monetarily from such activities, those cases were particularly fact dependent. For example, breach of fiduciary duty was found when a CFO tipped an analyst on an impending earnings shortfall in order to protect his own reputation.⁶ The analyst and his clients were thus able to “steal a march” on the unsuspecting buying public.⁷ In the main, however, company officials found it increasingly necessary for the benefit of their company to curry favor with the analyst community by selectively disclosing nonpublic material

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² Selective Disclosure and Insider Trading, Release No. 34-42259, 1999 SEC Lexis 2696 (Dec. 20, 1999).

³ See 17 C.F.R. §§ 243.100-103 (2001).

⁴ 463 U.S. 646 (1983).

⁵ See id.

⁶ See SEC v. Stevens, Litigation Release No. 12813, 1991 SEC Lexis 451 (Mar.19, 1991).

⁷ See id.

information to them. These activities generally would not involve a breach of fiduciary duty since they were done for the benefit of the company. As a result, the SEC lacked effective tools to stop this activity in order to protect unsuspecting trading markets. At the same time, most of these same company officials scrupulously adopted and observed strictures against trading by themselves and other similarly situated until after such information was released to the general public. This general behavior was rational in that it recognized the materiality of the information where sanctions existed and disclosed the information where there were no sanctions. One unintended result of this process was to turn many analysts into mere tippees. The growing awareness of this practice of selective disclosure led to increasing concern by the public and regulators even in the midst of the explosions of the late 1990's bull market.

In the final release adopting Regulation FD,⁸ the SEC staff refused to define materiality stating:

[W]hile we acknowledge in the "Proposing Release" that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material items" for purposes of Regulation FD. The problem addressed by this Regulation is the selective disclosure of corporate information of various types; the general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case.⁹

While not defining the term "materiality" the Commission gave some interpretative guidance by listing types of information or events that would call for careful review to determine whether they are material, namely, (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or a loss of a contract); (4) changes in control or in management; (5) changes in auditors or notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities such as defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.¹⁰ In what only can be characterized as a statement of accommodation, or perhaps a sign of weakness, the staff made the extraordinary statement: "...issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases."¹¹ Don't bet the ranch on that one!

⁸ Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, 2000 SEC Lexis 1672 (Aug. 15, 2000).

⁹ Id. at *35-6.

¹⁰ See id. at *37-8.

¹¹ Id. at *18.

The primary source of litigation and the concerns about the meaning of materiality comes from SEC Rule 10b-5¹² which makes it unlawful to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.¹³ Language in this regulation came not from Section 10(b) of the Securities Exchange Act of 1934¹⁴ itself, but rather from Section 17(a)(2) of the Securities Act of 1933.¹⁵

The term and concept of materiality is also used in the Ohio Securities Act.¹⁶ Section 1707.41¹⁷ establishes civil liability for “the loss or damage sustained by [a] person by reason of the falsity of any material statement ... or omission ... of material facts...” from any prospectus or similar document offering a security for sale.¹⁸ Section 1707.44(B)¹⁹ states that “[n]o person shall knowingly make or cause to be made any false representation concerning a material and relevant fact, in any oral statement or in any prospectus, circular, description, application, or written statement....”²⁰ Subparts (J)²¹ and (K)²² establish violations for statements and reports which are false in any material respect.²³ The concept is also utilized with respect to the disclosure called for in control bids in Sections 1707.041²⁴ and 1707.042.²⁵

The classic definition of materiality remains that set forth by the U.S. Supreme Court in 1976 in TSC. v. Northway.²⁶ It must be remembered that TSC involved the affect of the omission of information on the voting process under the proxy rules of Regulation 14A.²⁷ Regulation 14a-9²⁸ prohibits solicitations of proxies containing statements which, at the time and in the light of the circumstances under which made, are false or misleading with respect to any material fact, or which omit to state any material fact necessary in order to make the statements made not false or misleading.²⁹ The question presented was whether the omission of certain

¹² 17 C.F.R. § 240.10b-5 (2001).

¹³ See id.

¹⁴ 15 U.S.C. § 78j (2001).

¹⁵ Id. at § 77g.

¹⁶ Ohio Rev. Code Ann. § 1707 (2001).

¹⁷ Id. at § 1707.41.

¹⁸ Id.

¹⁹ Id. at § 1707.44(B).

²⁰ Id.

²¹ Id. at § 1707.44(J). The statute states:

No person, with purpose to deceive, shall make, issue, publish, or cause to be made, issued or published any statement or advertisement as to the value of securities, or as to the alleged facts affecting the value of securities, or as to the financial condition of any issuer of securities, when the person knows that such statement or advertisement is false in any material respect.

Id.

²² Id. at § 1707.44(K). "No person, with purpose to deceive, shall make, record, or publish or cause to be made, recorded, or published, a report of any transaction in securities which is false in any material respect." Id.

²³ See id. at § 1707.44(J), (K).

²⁴ Id. at § 1707.041.

²⁵ Id. at § 1707.042.

²⁶ 426 U.S. 438 (1976).

²⁷ See id.

²⁸ 17 C.F.R. § 240.14a-9 (2001).

²⁹ See id.

facts regarding a change in control of TSC were material.³⁰ The Supreme Court granted certiorari because of a conflict among the Courts of Appeals in defining materiality.³¹ The Court discussed the several definitions of materiality that had been utilized by various courts, including:

- All facts which a reasonable shareholder might consider important.
- Whether a reasonable man would attach importance to the facts misrepresented or omitted in determining his course of action.
- Whether there is a substantial likelihood that the misstatement or omission may have led a stockholder to grant a proxy.
- Facts which in reasonable and objective contemplation might affect the value of the securities.
- That the defect have a significant propensity to affect the voting process.³²

Finally, the court established the definition that is used today when it stated “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.... Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”³³

The test was further refined for contingent or speculative events by Basic v. Levinson in 1988.³⁴ The court there defined materiality concerning possible future events as depending upon a balancing of both the indicated probability that the event would occur and the anticipated magnitude of the event.³⁵

For example, in declining to find materiality in Abbott Laboratories vs. Airco, Inc.³⁶ the court noted that the fact that the market did not have a significant reaction to the ultimate disclosure of the particular information indicated that the information was not material.³⁷ It is of course much harder to measure the impact of nondisclosure of information on the voting process than is the case in market manipulation cases in which courts can look with 20/20 hindsight at actual market reactions when information does become public as a measure of whether it was actually material. Nevertheless, TSC has become the standard for market manipulation cases.

³⁰ See TSC, 426 U.S. at 440.

³¹ See id. at 443-44.

³² See id. at 445.

³³ Id. at 449.

³⁴ 485 U.S. 224, 231 (1988).

³⁵ See id. at 238.

³⁶ 1984 U.S. Dist. Lexis 20074 (N.D. Ill. Jan. 26, 1984).

³⁷ See id.

In construing its statutes, Ohio courts have spoken in terms of particular disclosures being “...misleading to appellate as reasonable investors...”³⁸ and again the same court spoke in terms of a test being that reasonable minds could not come to but one conclusion³⁹ and again spoke of the conclusions of a reasonable juror in connection with a disclosure of environmental costs in a prospectus issued by Mid-American Waste Systems, Inc.⁴⁰

Although the SEC has always refused to define materiality in a specific sense with respect to its anti-fraud rules, it has in fact established quantitative tests in accounting areas. For example, Item 2 of Form 8-K requires disclosures concerning acquisitions or dispositions of a significant amount of assets.⁴¹ The term “significant” is defined by a quantitative test of ten percent of total assets.⁴² A similar definition is used in Regulation S-X,⁴³ 1933 Act Rule 405⁴⁴ and 1934 Act Rule 12b-2⁴⁵ defining significant subsidiary. Note that the term “significant” rather than “material” is used. However, in August 1999 the SEC staff issued Staff Accounting Bulletin 99 in which it discussed materiality in financial statements and concluded that purely quantitative steps should be rejected in favor of a test that looks to surrounding circumstances and necessarily involves both quantitative and qualitative considerations for materiality.⁴⁶ The staff acknowledged the usefulness of the rule of thumb five percent test but noted that consideration of all relevant circumstances could well result in a judgment that misstatements below five percent are material.⁴⁷

Quantitative materiality remains a useful context in many areas. Usually it is expressed in terms of a percentage of assets, shareholders equity, net income or operating income. While some types of information may be extremely important to a company, they may not be important to shareholders in the market and therefore their statement or omission would not be material. For example, the creation and implementation of a strategic plan for a midwest service based company to enter into the northeast market may be a prime concern to the company and involve strict security to maintain the confidentiality of the move from competitors. However that information could involve less than one percent of assets or projected revenues. From a quantitative perspective such information would not be material to investors.

There is good reason to analyze the test of materiality differently in voting and market situations. In the voting circumstance, the judgment of whether a particular incorrect statement or omission is material must involve a subjective analysis of factors affecting voting decisions. In that sense, the concept of the “reasonable investor” is about as good as we can find. In the market area, however, the test can be more objective by measuring the impact of the disclosure on the market. Here there is no reason to confine the test to reasonable investors. A

³⁸ Federated Management Co. v. Coopers & Lybrand, 738 N.E.2d 842, 859 (Ohio Ct. App. 2000).

³⁹ See id.

⁴⁰ See id. at 864; see also Byrley v. Nationwide Life Insurance Co., 640 N.E.2d 187 (Ohio Ct. App. 1994).

⁴¹ See 17 C.F.R. § 249.308 (2001).

⁴² See id.

⁴³ Id. at § 210.

⁴⁴ Id. at § 230.405.

⁴⁵ Id. at § 240.12b-2.

⁴⁶ 7 Fed. Sec. L. Rep. (CCH) ¶¶ 75,563, 75,701 (Aug. 12, 1999).

⁴⁷ Id.

reasonableness test may well exclude a majority of investors in many of the recent roman candle Nasdaq flare-ups and flame outs. Even an unreasonable investor, however, deserves the protection of the securities laws. If, as is generally accepted, we analyze the market from the efficient market theory, then any act or omission which noticeably affects that market is material because the efficient market depends on the free flow of correct and complete information. Therefore, building on Basic vs. Levinson and the implication of TSC in market cases, one can say that a fact or omitted fact is material if an eventual disclosure causes a notable market reaction. Thus, at various times a misstatement of one percent in earnings could be material and in another day it may require a ten percent change to have a noticeable effect. Therefore, defining materiality is a nearly impossible task to achieve, but one that continues to evolve in our common law tradition.

But there is another view of materiality that must also be considered and that is qualitative materiality. Consider the requirement that the ages of directors and executive officers be set forth in proxy statements. Even if several ages were stated incorrectly by twenty percent, for example a 55 year old executive described as being 44, the information would not meet the TSC test of materiality. However, if the age of a dominant founder of a public company in the later stages of life were so understated it would be a material misstatement. One thinks of Walt Disney, Edward Lamb or at some point Bill Gates.

Likewise, breaches of fiduciary duty are almost always found to be material even though the amounts involved may involve a very small percent of assets. The case of the service business described above could also be material if the move signals a shift in business strategy involving greater risk or loss of a business advantage.

Thus it must be recognized that materiality is defined in the eyes of the beholder. This concept was noted by SEC Chairman Arthur Levitt, Jr. in a speech in September 1999 when he remarked:

....materiality [is] a word that captures the attention of both attorneys and accountants. Materiality is another way we build flexibility into financial reporting. Using the logic of diminishing returns, some items may be so insignificant that they are not worth measuring and reporting with exact precision.

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

In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of those so-called non-events simply don't matter.

This phenomenon has been painfully observed in the flame out phase of the recent roman candle market. Announcements of declines or anticipated declines in earnings of a penny or less, or involving less than a percent in some cases, has sparked market declines of far greater proportion. This type of reaction can also affect blue chip companies. For example, in February 2001 a major Dow Jones company predicted a decline from 2.5 percent to 4 percent in its earnings for the quarter. The announcement promptly lead to a 6.5 percent drop in its market price. That is the kind of information that, prior to Regulation FD, may have been selectively disclosed by some issuers to analysts thereby enabling the analysts and their clients to trade before market reaction set in once the news was publicly announced. The market reaction then would likely be gradual over time as the tippees sold but it would allow more unwitting buyers to take positions than is the case with a sudden market drop.

Shareholders in these recent instances seem to be technical or momentum investors to whom trends far outweigh other considerations such as dividend yields or price earnings ratios. This condition may not continue. Therefore, the one cent change so material to the market today may not be material in a more traditional market setting tomorrow. A hard and fast definition of materiality would serve neither market environment well. The "definition" of materiality has and will continue to differ over time and circumstance.

Meanwhile, the beat goes on. The Sarbanes-Oxley Act of 2002 employed the term "material" or a derivative thirty-two times.⁴⁸ However, in implementing standards of professional conduct for attorneys under that Act in 2003, the SEC stated "The final rule [SEC Rule 205] does not define the word 'material,' because that term has a well-established meaning under the federal securities laws and the Commission intends for that same meaning to apply here."⁴⁹

Perhaps we can tweak the TSC definition, at least at it applies to market versus voting circumstances. This suggestion is that an omitted fact be considered material if there is a substantial likelihood that an active trading market would react to it.

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⁴⁸ The Sarbanes-Oxley Act of 2002

⁴⁹ Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8185, 34-47276,