How Do You Know If Information is Material?

In short: try looking at it while standing in a reasonable investor's shoes.

Deciding whether a particular piece of information is material is probably one of the most difficult aspects of complying with Regulation FD. Remember, when the Commission initially adopted Reg. FD it deliberately chose not to define what was "material", electing instead to rely on definitions established through existing case law. In particular, in its Reg. FD adopting release, the Commission references two U.S. Supreme Court cases that address materiality: *TSC Industries, Inc. v. Northway, Inc.*, a 1976 case, and *Basic, Inc. v. Levinson et al.*, a 1988 case. Together the holdings from these two cases provide the foundation for an evaluation of whether information is material.

Materiality as Defined by the U.S. Supreme Court

In *TSC Industries, Inc.,* the U.S. Supreme Court establishes that information is material:

- "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding …" whether to take some action with respect to a company's securities, such as how to vote in response to a proxy solicitation or whether to buy, sell or hold the securities; or

- if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

In *Basic, Inc.,* the Court revisited the definition of materiality in the context of information and events that are contingent or speculative. Rejecting a "bright-line" test in favor of a more flexible standard that requires the exercise of judgment in light of the facts and circumstances, the Court held that determining whether a contingent or speculative event is material requires "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." Meaning that if the event in question has not yet happened, and it remains unclear as to whether it may happen at all, then determining whether it is material will require assessing the surrounding circumstances and weighing the probability of the event actually occurring against its significance to the company as a whole.

Materiality Guidance from the Commission

Beyond existing case law on materiality, the Commission also references Staff Accounting Bulletin No. 99 (SAB 99) in its Regulation FD adopting release. Staff Accounting Bulletins provide interpretive guidance regarding the Division of Corporation Finance and the Office of the Chief Accountant's views on accounting-related disclosure practices. SAB 99 addresses the use of quantitative and qualitative factors in assessing the materiality of financial information and cautions against using numerical rules of thumb (such as ruling any item under a 5% threshold as immaterial per se). Instead, in assessing the materiality of quantitatively small financial information, SAB 99 recommends considering whether the information:

- is capable of precise measurement or is based on an estimate, and the degree of imprecision inherent in the estimate;

- impacts earnings or other trends;

- hides a failure to meet analysts' consensus expectations;

- changes results from negative to positive, or vice versa;

- impacts a significant business segment;

- effects compliance with regulatory matters, loan covenants or other contractual requirements;

- effects management's compensation; or

- involves the concealment of an unlawful transaction.

Additionally, in the course of its discussion of materiality in the Reg. FD adopting release, the Commission also provided a non-exhaustive list of information and events that are likely to be considered material, including:

- earnings information;
- mergers, acquisitions, joint ventures or tender offers;
- acquisitions or dispositions of company assets;
- new products or discoveries;
- developments regarding customers or suppliers (such as the acquisition or loss of a contract);
- changes in control or management;
- changes in a company's auditors or receipt of notice that the company may no longer rely on an audit report;
- events regarding a company's securities, such as:
    - defaults on senior securities;
    - a call of securities for redemption;
    - repurchase plans;
    - stock splits or changes in dividends;
    - changes to the rights of shareholders;
    - the public or private sale of securities; and
- bankruptcies and receiverships.

Other Examples of Materiality

Other examples of information or events that may be considered material include:

- significant litigation or governmental investigations, whether pending or threatened;
- regulatory approvals or changes in regulations;
- changes in executive compensation;
- changes to a company's credit rating;
- labor disputes or negotiations;
- significant product defects, recalls or returns;
- significant pricing changes; and
- potential proxy contests

The Commission's guidance and foregoing examples are not meant to be an exhaustive checklist. Materiality is a contextual determination, not a mechanical one, and what is material information for one company or in one situation may not be so for another.

Materiality from an Enforcement Perspective

Shortly after Regulation FD took effect Richard Walker, then the Director of the Commission's Division of Enforcement, delivered a speech to the Securities Industry Association (one of the predecessor organizations to the Securities Industry Financial Markets Association (SIFMA)), sharing his views, from an enforcement perspective, on material information. In particular, Mr. Walker noted that the Commission would not look to second-guess reasonable materiality determinations made in good faith, even if it did not agree with them. He went on to state that an incorrect materiality determination would have to represent an "extreme departure" from a reasonable standard of care before the Commission would bring an enforcement action under Reg. FD.

Mr. Walker also offered up some of his own guidance on evaluating whether information is material. Using the example of a company confirming earnings guidance, he suggested that the company ask itself three questions in considering materiality:

- Where are we in the earnings cycle?
- How much time has passed since the initial guidance was issued?
- Has anything important transpired between the issuance of the initial guidance and the proposed confirmation that would cause a reasonable investor to question the accuracy of the original guidance?

Jigsaw Puzzles Are Material; Mosaics Are Not

A company cannot take a piece of material information, break it down into immaterial parts and selectively disclose those parts, as if it were a jigsaw puzzle. On the other hand, if a company discloses a piece of immaterial information to an analyst, and that analyst, by some combination of skill, industry knowledge and insight, is able to use the information to complete a "mosaic" of information that, taken together, reveals material information about the company, the initial immaterial disclosure will not then be rendered material. This concept may sound vaguely familiar; it's probably because the mosaic theory is one of the defenses being raised in the Galleon Group expert-network case.

It All Comes Down to Exercising Reasonable Judgment

When making a materiality determination you should always consider the point of view of a *reasonable* investor (not the one that gets investment advice from their psychic or the one with a Bloomberg terminal in every room in their home).

Is a reasonable investor substantially likely to consider the information in question important to their investment decision? Would they view it as significantly altering the total mix of information available? If the answer to either of these questions is yes, then the information is most likely material.

What about information that is speculative or contingent on the happening of some other event? For example, what if your company is in the oil and gas industry and it has just begun exploratory drilling on a new well; is that information alone material? What if the new well is just one of a hundred wells that the company is currently exploring; does that influence your answer? What then, if very preliminary tests indicate that this well may have an extremely large oil reserve? Determining materiality in the context of speculative or contingent events requires that you look at all of the facts and circumstances surrounding the event and balance the likelihood of its occurrence with its anticipated impact on the company as a whole.