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by A. A. Sommer, Jr.*

Perhaps the enhanced importance of the concept, "materiality", in the federal securities laws is best evidenced by the fact that this institute is being held. Rarely, if ever, has there been a two-day forum which devoted itself to the elucidation and discussion of a single critical word or concept in this scheme of laws. The existence of this conference is less an indication of the historic importance of that term than that it increasingly has become a source of confusion, misunderstanding, concern and apprehension.

It is not enough to suggest that this has come about because of the problems related to domestic political contributions and illegal payments overseas. The term has always been a slippery, elusive and uncertain one. Like the concept of negligence, the value of the concept of materiality derives

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from its very breadth, imprecision and defiance of exact definition. It reflects the complexity of human affairs, the multitude of situations in which human beings find themselves involved and the multiplicity of relationships that they create. As with negligence, so with materiality, we have defined this concept in terms of a hypothetical human being possessed of certain qualities of prudence and judgment that at least sometimes escape us as individuals.

The notion of materiality did not spring full blown from the mind of Congress in 1933 or 1934. Rather, this concept has its origins deep in common law. One of the elements of the causes of action known as "deceit" and fraud was the the misrepresentation be "material."

Why has there been, in recent years particularly, so much concern with the concept of materiality? While all of us who practiced securities law in the '50's and '60's were constantly confronted with difficult decisions concerning the materiality of information, certainly in recent years there has been heightened concern with the limits and meaning of materiality.

Enormous consequences follow from the concept of materiality. It determines in large measure the contents of registration statements, prospectuses, financial statements, periodic reports and a host of other disclosure documents.

But of perhaps more importance, it has enormous liability consequences. Materiality is at the heart of most securities cases. For instance, in Feit v. Leasco Data Processing Equipment Corp., the liability of a number of defendants there turned simply on the question of whether the disclosure of the "surplus surplus" of an insurance company was a material matter which was required, not by an explicit provision of Form S-1 or the Guidelines for the preparation of registration statements, but rather by the general provisions of Section 11 which base liability on material omissions in 1933 Act registration statements. Similarly in the Bar-Chris case, the court made a number of determinations with respect to materiality, perhaps the most notable of which was a determination that the errors in the audited financial statements with respect to current assets and current liabilities were indeed material, although a 14%

error in earnings per share was not.

The consequences of materiality, of course, go far beyond civil liability. There lurks in the shadows the danger that in some circumstances a material misstatement or omission might trigger criminal liability. Perhaps the most dramatic example of this was afforded in U.S. v. Simon where implicit in the court's decision was the conclusion that the omission of detail in a footnote to the financial statements with respect to the collateral securing an obligation to the corporation and other omissions and misstatements were material, which, combined with the requisite state of mind, gave rise to criminal liability for the auditors in that case.

Despite a constant yearning for greater precision and certainty, the statutes administered by the Commission and the rules which the Commission has adopted under them clearly evidence the Congressional and Commission conclusion that precise rules simply cannot be framed to embrace every situation.

As a consequence of the vagueness and uncertainty attending the concept of materiality and the apprehensions over the consequences of omitting anything which might be deemed material, prospectuses and proxy statements have gotten longer, the footnotes to the financial statements have become more extended and obscure and it is questionable whether in the process disclosure has not in fact been impeded by this all-embracing concern with materiality. Not infrequently, the staff will suggest that prolix portions of a registration statement be omitted, only to be met by adamant refusal on the part of counsel for underwriters and issuers because of concern that somewhere down the road a court might determine, notwithstanding the administrative determination by the Commission's staff, that the omitted information was indeed material. I would suggest that these concerns are not without foundation and that the efforts of some courts and the Commission to expand the outer limits of materiality may in some measure have imperilled meaningful disclosure.

Until the fairly recent past, materiality was generally thought of in terms of financial or economic materiality -- how many dollars were involved, to what extent would a circumstance or event impact profits or assets or net worth? The measures were generally balance sheet or income statement items and the materiality of any fact was sought to be judged by these measures. An example is the one I alluded to earlier with regard to the materiality of current assets and current liability figures contained in the financial statements of Bar-Chris. However, as a consequence of a number of forces which I will identify in a moment, this mode of measure has to some extent been eroded.

This expansion of notions of materiality, and these departures from more conventional measures, have been the result of a number of forces. For one thing, as social activist groups have become more vocal in our society, they have seen in the federal disclosure laws opportunities to advance their causes by compelling disclosure of corporate attitudes and conduct with regard to a number of social issues. Thus they have suggested that there are in the country large numbers of so-called "ethical investors" who are concerned with corporations' records with regard to employment, environmental protection and innumerable other matters. They contend that in determining the necessity of disclosing such matters, the extent to which these attitudes and policies presently or might in the future impact the economic performance of the company is secondary, although they do invariably argue that such matters may have economic impact which of itself would mandate disclosure; they emphasize that these investors may utilize such information in making investment decisions or voting their shares and thus to them, at least, the information is material in the traditional sense as information which at least some reasonably prudent investors need in order to make rational investment decisions.

In some cases, commentators favorable to social disclosure have suggested what might be described as a "statistical" approach to the problem of materiality, that is, that is material which may be of importance to a significantly large number of potential investors in making their decisions. In a seminar sponsored by the American Bar Association in 1972, Bevis Longstreth, a distinguished practitioner, said

> "But at some point, if [the concern of some institutions with the social aspects of corporations in which they have invested] does continue, there will be a significant number of investors wanting data in order to measure an investment by these tests. At that point perhaps those matters, even though soft rather than hard in the sense of profits, may become material even under existing standards of the securities acts...I think that at a point where there is a significant number of investors who have that viewpoint, the SEC does have the power and, I would think should mandate disclosure in response to a felt need of a significant number of investors."

In <u>Feit</u> v. <u>Leasco Data Processing Equipment Corp.</u>, Judge Weinstein gave judicial recognition to this when he said,

> "A fair summary of the rule stated in terms of probability is that a fact is proved to be material when it is more probable than not that a significant number of traders would have wanted to know it before deciding to deal in the security at the time and price in question. What is statistically significant will vary with the legal situation...Anything in the order of 10% of either the number of potential traders or those potentially making 10% of the volume of sales would more than suffice."

These approaches were vigorously asserted by critics of the Commission's rulemaking with respect to environmental and other social issues in the course of the Commission's hearings arising out of the Natural Resources Defense Council, Inc. v. SEC litigation in which the court faulted the Commission's procedures in rejecting the rulemaking proposals of environmental and other socially oriented groups. Notwithstanding the calculation contained in Release No. 33-5627 concerning the small amount of stock represented by those urging expansion of the Commission's disclosure requirements with respect to social issues, the Commission has never adopted this approach in determining appropriate standards of materiality.

Adding to the complexity of this problem, of course, is the sometimes rather faintly heard suggestion that perhaps standards for determining materiality differ depending upon the context in which they are applied. For instance, it may well be that something may be regarded as material for purposes of determining the necesity of its inclusion in a registration statement under the 1933 Act, whereas it might not be material in determining the adequacy of a press release or in judging whether improper insider trading has occurred. Similarly, it may well be that courts confronting disclosure in proxy or tender offer situations will apply different standards of materiality than they might otherwise; surely this was the intimation of Judge Friendly in the Electronic Specialty Co. v. International Controls Corporation in 1969.

Such a distinction is suggested in Judge Weinstein's opinion in Feit v. Leasco Data Processing Equipment Corp., where he says

> "Being a formal and legally required document, the disclosure in a prospectus can be held to a high standard - i.e., disclosure is required when only a relatively small percentage of traders would want to know before making a decision."

It is also developed in the proposed American Law Institute Federal Securities Code which requires that, as the basis for determining that illegal insider trading has occurred, not only must the undisclosed fact be "material" but it must also be of "special significance" which is defined as a fact that upon being made generally available is likely to affect the market price of the security to a significant extent or one which a reasonable person would attach special importance to in determining his course of action.

Partially as a consequence of suggestions by such commentators as Homer Kripke and Bruce Alan Mann that the Commission's traditional opposition to forward looking information had been obsoleted not only because of analytical considerations, but because of judicial developments such as the decision in Gerstle v. Gamble-Skogmo, questions were raised as to whether in fact the Commission's restraints on the inclusion of such information in formal documents might not be depriving investors of the most material information available.

The reexamination of materiality concepts has been further fueled by the increased institutional participation in the markets of this country. It is estimated that at the present time approximately 45% of the stock listed on the New York Stock Exchange is held by institutions and this portion has been steadily increasing. Obviously, institutional investors and their managers are better equipped to deal with highly complex, detailed financial information than the so-called "average" investor. As a result, it may be argued that a much greater volume of information, particularly complex and detailed information, becomes "material" to the institutional investor which, because of the difficulty of comprehending and assimilating, might be of little, if any, use to the ordinary, average investor. This, of course, introduces an additional complexity in the picture, because neither the rules of the Commission, its administrative determinations or judicial decisions have differentiated between investors on the basis of their sophistication, experience or ability to deal effectively with information.

Closely related, of course, to the problem of properly informing the institutional investor have been the suggestions that perhaps new methods of investment analysis have in some measure obsoleted the present disclosure system which is deeply rooted in fundamental security analysis of the Graham-Dodd variety. It has been suggested that perhaps there should be incorporated in prospectuses and other filings with the Commission information with regard to beta factors and the other sophisticated tools which portfolio managers currently utilize. This, of course, would introduce an entirely new and different dimension into the disclosure process. Somewhat related to this have been suggestions that there should be included information with regard to the industry in which an issuer operates, its position in the industry, various macro-economic data which might be of importance in assessing the future prospects of the company and so on.

The problem of materiality has reached new heights of complexity and controversy as a consequence of the Watergate investigations. During the course of those, it was determined that a large number of American corporations had illegally made contributions to various political campaigns, notably the Presidential campaign in 1972. The Commission became interested in these matters as a consequence of its concern with the adequacy of corporate disclosure, thus confronting the Commission with the question whether the failure of corporations to disclose the fact of such illegal contributions was information material to investors and thus should have been included, if not because of any specific requirement, then at least because of the general requirements that material information be disclosed to the extent necessary to prevent other information in the filing from being misleading. As the Commission investigated these matters, it made several startling discoveries. For one thing, it learned that in most instances, such payments were accompanied by various kinds of financial footwork involving phony subsidiaries used as conduits, large commission payments which were converted to cash and returned to this country, Swiss bank accounts - in general, conduct totally inconsistent with the standards and traditions of financial reporting that have been sought to be established over the last four decades - all for the purpose of concealment. Furthermore, it was found that the funds from which, and the conduits through which, political payments were made were also utilized to make other illegal or at least questionable payments overseas. In some cases it appeared that these payments were in the nature of bribes to government officials, excessive commissions under circumstances where it appeared likely the recipient would use them for illegal purposes and so on. The question confronting the Commission was whether these payments, not previously the subject matter of any charges by any other governmental agency, formal or informal, and not known officially otherwise than as a result of the Commission's investigation, should be disclosed by the corporations as a consequence of their obligations of disclosure under the federal securities laws. This was and continues to be an extremely intricate and difficult problem not susceptible of immediate or totally satisfactory solution.

The Commission has responded to these forces and problems in various ways. As a consequence of the district court mandate in the Natural Resources Defense Council case, the Commission conducted an extensive rulemaking proceeding at which it received the testimony of 54 witnesses, totalling in excess of 10,000 pages, as well as 353 written submissions. On the basis of this record, the Commission released for comment additional proposed rules with regard to the disclosure of matters pertaining to environmental protection, but rejected proposals to extend its requirements with regard to disclosure concerning other socially significant matters.

The Commission differentiated the necessity of expanding disclosure with regard to environmental matters from proposed expansions of disclosure with regard to other socially significant matters on the basis of the provisions of the National Environmental Policy Act of 1969 which required that all federal agencies accord special priority to the implementation of the policies enunciated in that Act. In the absence of such a statutory mandate, the Commission included in its release accompanying the proposed new environmental disclosure rules language reflecting adherence to traditional economic and financial concepts of materiality.

In response to the increasing institutionalization of the markets, accompanied by an increase both in number and in quality of financial analysts, the Commission has sought to develop the doctrine of differential disclosure which requires that in filings with the Commission which are not widely disseminated, but which are available in the files of the Commission to anyone, there must be included certain detailed financial information which is not required to be included in the financial statements contained in the annual report which is circulated more broadly. This resulted in some concern on the part of accountants who contended in effect that the concept of materiality was univocal, that information material to the financial statement in the Form 10-K was material to the financial statements in the annual report to shareholders, and that the omission of information contained in the financial statements incorporated in a Form 10-K might result in additional explsures to liability. I have treated that subject at some length on another occasion and again will forego the temptation to re-plow that ground.

The Commission has recognized clearly the importance of forward looking information to investors and has put out for comment a proposal with respect to estimates, appraisals and forecasts which has drawn heavy fire, not so much because of concern about the materiality of the information, but rather, on the basis of the comments I have seen, because of the complexity of the system proposed to implement this determination by the Commission as to the importance of this information. I am confident that at some appropriate time the Commission will respond to these comments and publish a revised proposal.

Beyond what the Commission has done in exploring the notion of materiality, it seems to me that there is considerable merit in the expansion of empirical studies with regard to the kinds of information that are of importance to various classes of investors. Recently two such studies have, to my knowledge, been made. In one, Gyan Chandra surveyed accountants and financial analysts with respect to the kinds of financial information they deemed to be of material importance. In another, Larry Godwin surveyed analysts and shareholders with respect to the importance they attach to various kinds of information. These studies, in my estimation, provide us with extremely interesting insights. Simply as one example, in the Godwin study ordinary shareholders attached great importance to the political contributions made by corporations whereas the professional analysts gave them much less attention. While the all-out adoption of any such statistical approach to materiality has severe shortcomings, nonetheless, I think such studies can be of considerable assistance to the Commission in developing disclosure policies. Even if such an approach were taken with respect to rulemaking, of course, there would remain large areas in which it would be impossible to apply such techniques and we would remain dependent upon the informed judgment of attorneys, accountants and businessmen with respect to matters of materiality.

The most troublesome problem confronted by the Commission has been that of political contributions and illegal payments overseas. In many instances, the amounts of money paid measured in terms of the corporation's revenues, income, assets or net worth would not rise to the level of materiality. The problem which confronted the Commission was whether these somewhat customary measures define the limits of materiality. Aren't there, we asked ourselves, circumstances under which such payments, even though immaterial in and of themselves, may nontheless relate to such substantial parts of the corporation's business that disclosure should be made? Taking the simplest case, if a corporation has secured a clearly material amount of business by bribing those in control of a country rather than through more conventional means, such as competitive excellence, is this something that is important for investors to know? Might it be argued that such business is more vulnerable, more fragile, more susceptible to loss than business secured through more customary means? Similarly, might it be argued that failure to disclose the use by corporate officers of corporate resources to assist in the financing of political campaigns in contravention of laws of the United States violates the Federal securities laws, almost regardless of the amounts of monies that are involved simply because it provides a startling and dramatic and meaningful example of an abandonment of their stewardship by corporate officers?

At another level, as I indicated, most of the instances we have uncovered involving illegal payments overseas and domestic illegal political contributions have been covered up in some fashion on the books of the company. This circumstance poses the additional difficult question: is it not material to an investor to know that the top officers of the company have countenanced and in some instances instigated the falsification of the corporation's books and records in an effort to conceal the information from auditors, law enforcement agencies, probing shareholders and others?

Increasingly, it has been suggested that information such as this is important because of the insight it provides to investors as to the character and quality of management. I think most investors have recognized for a long time that the single most important factor in making judgments concerning the future prospects of a corporation is the quality of the management. The Commission has for a long time required that in filings with it there be included considerable information with regard to management. At the present time, we require information with regard to the age of the principal officers and directors; their compensation, options, pension benefits and the like; their employment records during the previous five years; any criminal convictions, bankruptcies and similar proceedings. Beyond that, as far as filings with the Commission are concerned, the principal resource available to investors in assessing management is simply the historical record of the company for the period that management has been involved with it. In the past, the Commission in the Franchard case, decided in 1964, rejected a proposal by the staff that it fault a document for failing to disclose that the directors were really simply pawns of top management, thus rejecting such judgmental disclosures with regard to the qualifications of management.

Of course, these expansions of the concept of materiality have been aided considerably by the Supreme Court decisions which have expressed the test in terms of information which "might" have a significant propensity (as stated in the Mills v. Electric Autolite case) to influence the judgment of a reasonable investor. When the test is phrased in that fashion, it is possible to embrace under the umbrella of materiality a tremendous variety of information which in earlier and less troubled days would clearly not have passed the threshold. It might be noted that the Supreme Court has granted certiorari in the case of TSC Industries v. Northway, Inc., a case which involves the question of the proper test of materiality, thus creating widespread speculation that the Supreme Court may tighten the standard which it previously expressed.

I think it is extremely important that efforts to understand the investment process, the sort of information that is important to investors, the differences in information which have relevance to various kinds of investors, the application of the materiality concept to new problems and in new circumstances continue to expand. However, I must express grave misgivings about the danger that logical constructs which may well serve and resolve the complexities of one problem may, carried a few steps further, involve us in disclosure problems far beyond those contemplated by the authors of the statutes under which we operate and take us far beyond good policy. If we accept, as the Commission has, that illegal payments overseas which relate to material amounts of business must be disclosed, must we conclude that, before any charges are made by outside parties, a company which has perhaps violated the antitrust laws with regard to a significant acquisition, or has determined that it has been in violation of the federal drug laws with regard to a material product, or which has engaged in the practice of bribing union officials with respect to a material part of its business or which, engaged in the construction business, has somewhere or other paid off governmental officials in this country, must disclose those offenses, and that if they do not, not only has the corporation violated the substantive laws concerned, but it has violated the disclosure requirements of the federal securities laws as well?

Similarly, if we insist upon including more information that may give us insight into the integrity or competence of management, must we compel the disclosure of the fact that the chief executive officer occasionally shows up drunk at the office, or that the treasurer is under investigation by the IRS, or that the executive vice president is having an affair with his secretary, or that the executives use the company's jet for personal purposes on occasions? The implications of these concepts are limitless - and troubling.

It is tempting to move down this road, but it seems to me that it is a temptation which, yielded to, will exact a tremendous price. The hasty expansion of materiality concepts along this path may well result in a strain on the resources of the Commission that will impair seriously its ability to do that which it has classically done so well -- police the disclosure system and the securities markets. If it becomes commonplace for the Commission to charge violations of the federal securities laws because of the failure to disclose illegal conduct in a company's activities, even though no charges have been made by any other authority with regard to that conduct, then I would suggest that such disclosure will lose much of its potency and impact on the public. Furthermore, the unlimited expansion of these concepts will result in documents even more burdensome, difficult to comprehend and lengthy than those we know at the present time. We would be confronted with an additional great and sprawling area of uncertainty out of which can grow tremendous additional liabilities and burdens to American business.

I think the Commission must reflect carefully upon the directions in which logic may impel it as it explores the outer limits of the concepts of materiality. I would suggest that the Commission should carefully reflect upon the self-restraint which it expressed in the Franchard case when it resisted the temptation to expand the effort to identify management's shortcomings into difficult and potentially confusing areas.

It is extremely important to keep in perspective what the disclosure documents filed with the Commission and circulated to investors are supposed to be. If the enforcement of the disclosure laws becomes in effect a substitute for the enforcement of other substantive laws, then I would suggest that the Commission will have been diverted from its true mission which is to provide information to investors about matters that are likely to impact the future prospects of the corporation, as well as historical information.

I suppose my conclusion, the "bottom line" as Alan Levenson is fond of calling it, is that the Commission should push ahead in this sensitive area but with a great deal of caution and restraint. It is better that laws be directly enforced by the appropriate authorities than that there be indirect enforcement by compelling corporations to point the finger of sin at themselves. While it is true that corporations do not enjoy rights under the Fifth

Amendment, nonetheless, it seems to me that we would be substantially reshaping the structure of our society and our laws if we concluded that uncharged violations of the law always had to be disclosed because of materiality concepts under the federal securities laws. Materiality is a concept that will bear virtually any burden; it can justify almost any disclosure; it can be expanded all but limitlessly. But we must constantly bear in mind that overloading it, unduly burdening it, excessively expanding it, may result in significant changes in the role of the Commission, the role of other enforcement agencies, and our ability to carry out our statutory duties.

I know these remarks are easily susceptible to misinterpretation. Some will suggest that I countenance corporate immorality and illegality; nothing could be further from the truth. I have spoken repeatedly on the dismay that I have felt as we have learned more and more about abuses of corporate power, misconduct in the use of corporate money, abuse of corporate privilege. I deplore this and I would hope earnestly that the appropriate authorities move to the fullest extent of their vigor and their power to punish such conduct and prevent its occurrence in the future; in that effort I would also earnestly hope that they would be assisted significantly by the corporate community -- and by their accountants and their lawyers. However, I think it is time that we reassess the extent to which we wish the

Securities and Exchange Commission to be the guarantor of corporate conduct at home and abroad. Intimately tied-in with that question, of course, is the notion of materiality. Let us treat it with circumspection, with restraint, with a healthy sense of continuity with the past, and a realization that we can easily damage the credibility and effectiveness of the entire disclosure system if we try to stretch this one word over too big an elephant.