

## American University Law Review

---

Volume 52 | Issue 5

Article 1

---

2003

# Materiality Guidance in the Context of Insider Trading: A Call for Action

Joan MacLeod Heminway  
[heminway@libra.law.utk.edu](mailto:heminway@libra.law.utk.edu)

Follow this and additional works at: <http://digitalcommons.wcl.american.edu/aulr>

 Part of the [Law Commons](#)

---

### Recommended Citation

Heminway, Joan MacLeod. "Materiality Guidance in the Context of Insider Trading: A Call for Action." American University Law Review 52, no.3 (2003): 1131-1212.

This Article is brought to you for free and open access by the Washington College of Law Journals & Law Reviews at Digital Commons @ American University Washington College of Law. It has been accepted for inclusion in American University Law Review by an authorized administrator of Digital Commons @ American University Washington College of Law. For more information, please contact [fbrown@wcl.american.edu](mailto:fbrown@wcl.american.edu).

---

# Materiality Guidance in the Context of Insider Trading: A Call for Action

## ARTICLES

MATERIALITY GUIDANCE IN THE  
CONTEXT OF INSIDER TRADING: A CALL  
FOR ACTION

JOAN MACLEOD HEMINWAY\*

TABLE OF CONTENTS

Introduction .....	1132
I. Background .....	1136
II. Materiality and Insider Trading.....	1145
A. Two Examples; One Key Question .....	1145
1. Example #1—Improper balance sheet accounting...1145	
2. Example #2—Failed merger discussions .....	1146
3. The materiality question.....	1148
B. The Applicable Legal Standard.....	1148
C. Materiality Analysis in Insider Trading Cases .....	1156
D. Inconclusive Answers .....	1161
1. Example #1—Improper balance sheet accounting...1161	
2. Example #2—Failed merger discussions .....	1163
3. An important, albeit limited, analytical role for decisional law .....	1165

---

\* Associate Professor, *The University of Tennessee College of Law*, A.B. 1982, *Brown University*; J.D. 1985, *New York University School of Law*. An earlier version of this Article was presented at the annual meeting of the Southeastern Association of Law Schools in July 2002. I thank Erica Beecher-Monas, Dana Brakman Reiser, Judy Cornett, Joe Franco, Amy Hess, Don Leatherman, Bob Lloyd, Colleen Medill, and Carol Parker, all of whom provided helpful comments on earlier drafts of all or part of this Article. Able research assistance was provided by Irmie K. Blanton. I also thank David Brewster, Margaret Brown, Kent Coit, Margaret Crouse, Louis Goodman, Vern Larkin, and George Skelly, my former colleagues at the Boston office of Skadden, Arps, Slate, Meagher & Flom LLP, with whom (among others) I worked on endless materiality analyses over the years, including those that form the basis of the argument and proposal set forth in this Article. Finally, I am grateful to The University of Tennessee College of Law, which supported work on this Article with summer research grant funding.

1132	AMERICAN UNIVERSITY LAW REVIEW	[Vol. 52:1131
	E. Why Ambiguity Matters .....	1165
III.	Key Legislative, Regulatory, and Judicial Policies .....	1167
	A. Policies Underlying the Application of Rule 10b-5 to Insider Trading Cases .....	1167
	B. Policies Underlying Section 10(b) and Rule 10b-5 .....	1169
	C. Policy Support for Disclosure Under the 1934 Act Generally .....	1170
IV.	Impacts on Stockholder Value .....	1172
	A. Insider Trading and Stockholder Value .....	1173
	B. Foregone or Delayed Transactions .....	1174
	C. Materiality Assessment and Decision-Making as a Management Distraction .....	1177
	D. The Cost of Outside Counsel .....	1180
V.	Stockholder Value in the Current Class Action Litigation Environment .....	1183
	A. Historical Context of the Current Securities Fraud Class Action Environment .....	1184
	B. Insider Trading Claims in the Securities Fraud Class Action Environment .....	1187
	C. The Need for Substantive Reform .....	1190
VI.	A Proposal .....	1191
	A. Suggested Approach to Fashioning Appropriate Materiality Guidance .....	1192
	1. Recognizing the “disclose or abstain” rule for what it is .....	1193
	2. An existing regulatory example .....	1193
	3. Defining the key elements of materiality and methods of measurement in the insider trading context .....	1196
	B. Application of the Suggested Approach to the Two Examples .....	1199
	1. Example #1—Improper balance sheet accounting .....	1200
	2. Example #2—Failed merger discussions .....	1204
	Conclusion .....	1211

## INTRODUCTION

Recent corporate scandals involving Enron Corp., Global Crossing Ltd., Tyco International Ltd., and WorldCom Inc. (among others) have focused regulatory, media, and overall public attention on corporate and individual securities fraud, including insider trading. This focus is driving a new, fast-moving, aggressive regulatory agenda<sup>1</sup>

1. The agenda to date has included, among other things, the adoption by Congress of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter Sarbanes-Oxley], and a series of regulatory initiatives at the U.S. Securities and Exchange Commission (“SEC”). *See, e.g.*, 17 C.F.R. § 205.1-205.7 (2003); *id.* § 240.10A-2 (2003); *id.* §§ 228.303(c), 229.303(a)(4)-(5), 249.220f (Form 20-F Items 5E-5G), 249.240f (Form 40-F ¶¶ (11)-(13)) (2003). Interestingly, Professor Stephen Bainbridge predicted this phenomenon with uncanny accuracy,

consisting principally of proposed changes to public company accounting practices, corporate governance, and federal securities regulation and fraud enforcement.<sup>2</sup> What a difference a few years make . . .

It was just two years ago, on July 19, 2001, that Harvey L. Pitt, then the newly confirmed Chairman of the SEC, announced a comprehensive review of the SEC's rules, noting, as reported in *The New York Times* on July 20, 2001, that the complexity of the current rules makes it "difficult for those obliged to comply with the rules to understand their obligations . . ."<sup>3</sup> Soon thereafter, concern over corporate fraud—together with Chairman Pitt's deemed ineffectual (and allegedly biased) management of that issue—stole the spotlight.<sup>4</sup> While seemingly all but forgotten by some, former Chairman Pitt's original regulatory agenda continues to have validity in the current environment.<sup>5</sup> In particular, in the insider trading<sup>6</sup>

---

some might say, in 2000. See Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1058 n.169 (2000) ("[A] few well-publicized securities fraud cases could result in the adoption of onerous securities regulation even if the vast majority of corporate managers are honest and trustworthy.").

2. These changes have been heralded and trumpeted by the press from the time that news of the full extent of Enron Corp.'s corporate fraud first became public. See, e.g., David Callahan, *Private Sector, Public Doubts*, N.Y. TIMES, Jan. 15, 2002, at A21; Stephen Labaton, *S.E.C.'s Leader Evolves Slowly in a Climate Enron Altered*, N.Y. TIMES, May 3, 2002, at C1; David Leonhardt, *A Prime Example of Anything-Goes Executive Pay*, N.Y. TIMES, June 4, 2002, at C1; Bruce Nussbaum, *Can Trust Be Rebuilt?*, BUS. WK., July 8, 2002, at 32; Lee Walczak et al., *Let the Reforms Begin*, BUS. WK., July 22, 2002, at 26.

3. Stephen Labaton, *S.E.C. Nominee Says Rules Need a Review*, N.Y. TIMES, July 20, 2001, at C1.

4. During former Chairman Pitt's term in office, reports of his ineffectuality and bias were widely disseminated and analyzed by national and local news media. See, e.g., Christopher Byron, *Congratulations, Bill—Here's a Friendly To-Do List for the SEC*, N.Y. POST, Dec. 11, 2002, at 031 (describing former Chairman Pitt as "hilariously ineffectual"); Greg Farrell, *SEC Chief Discovers Public Relations Can Be the Pits*, USA TODAY, Oct. 14, 2002, at 3B (setting forth a chronology of controversies during Pitt's term at the SEC); *What Brokers Want From Pitt: How's the SEC Chairman Doing?*, ON WALL STREET, Oct. 1, 2002, LEXIS, News & Business Library, News Group File (reporting the results of a survey of brokers regarding their views on former Chairman Pitt).

5. Interestingly, former Chairman Pitt, himself, publicly admitted that he had accelerated his original regulatory agenda in the wake of the publicized fraud at Enron Corporation. See Labaton, *supra* note 2.

6. The term "insider trading" as used in this Article refers to the classical theory of insider trading, as opposed to the misappropriation theory adopted by the Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997). Under the classical theory of insider trading, liability results from the trading of an issuer's securities by an insider while the insider is in possession of "material, nonpublic information." See *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (describing the objectives of this classical theory of insider trading liability); Trading "on the basis of" material nonpublic information in insider trading cases, 17 C.F.R. § 240.10b5-1 (2003) (defining when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases). Moreover, this Article focuses on

area, the Pitt regulatory agenda could have represented an extension of the SEC's recent foray into rule-making that attempts to bring more clarity to the murky substance of U.S. insider trading regulation under Rule 10b-5<sup>7</sup> under the Securities Exchange Act of 1934, as amended (the "1934 Act").<sup>8</sup> Substantive reform to add clarity to our federal securities laws and regulations, especially those governing aspects of securities fraud, is more needed now than ever. Only with this enhanced clarity can specific actions be proscribed; only with enhanced clarity can those who violate antifraud provisions be efficiently prosecuted and convicted or otherwise held accountable or liable.<sup>9</sup>

Moreover, greater substantive clarity in U.S. insider trading regulation enhances the transaction planning process for public issuers<sup>10</sup> of securities and their insiders.<sup>11</sup> A key aspect of U.S. insider

---

trades (not tips) by primary insiders (not their tippees). For information on tipper and tippee liability for insider trading, see *Dirks v. SEC*, 463 U.S. 646 (1983).

7. 17 C.F.R. § 240.10b-5 (2003) [hereinafter Rule 10b-5]. Among other things, Rule 10b-5 prohibits individuals and entities from directly or indirectly using interstate commerce, the mail, or a facility of a national securities exchange:

[t]o employ any device, scheme or artifice to defraud, . . . [t]o 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 the light of the circumstances under which they were made, not misleading, or . . . [t]o engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.

*Id.*

8. 15 U.S.C. §§ 78a-78mm (2003).

9. See Mike France & Dan Carney, *Why Corporate Crooks Are Tough to Nail*, BUS. WK., July 1, 2002, at 35 (noting that successful prosecution of corporate wrongdoers is difficult because, among other things, "[t]he laws regulating companies are ambiguous").

10. "Public issuers" or "issuers" refers to issuers of publicly traded securities registered under Section 12 of the 1934 Act. Penalties, 15 U.S.C. § 78l (2003). These issuers must comply with the same restrictions on insider trading to which their insiders are subject under Rule 10b-5. See, e.g., *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203-04 (1st Cir. 1996) (conceptualizing, by analogy, corporate issuers as individual insiders for disclosure purposes); Steven E. Bochner & Samir Bukhari, *The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives*, 7 STAN. J.L. BUS. & FIN. 225, 229 (2002) (discussing generally the duty of issuers and insiders to disclose material nonpublic information or refrain from engaging in stock sales and market transactions); Harry S. Gerla, *Issuers Raising Capital Directly from Investors: What Disclosure Does Rule 10b-5 Require?*, 28 IOWA J. CORP. L. 111, 116 (2002) (stating that "[a]ll courts and most commentators have assumed that the issuer of securities is the ultimate insider" for purposes of U.S. insider trading regulation); Nicholas J. Guttilla, *Securities Regulation-Disclosure of Intra-Quarter Performance Information Constituting Extreme Departure from Public Information Required in Shelf Registration Prospectus-Shaw v. Digital Equipment Corp.*, 82 F.3d 1194 (1st Cir. 1996), 31 SUFFOLK U. L. REV. 1023, 1028-29 (1998) (noting that SEC insider trading proscriptions apply equally to insiders and corporate issuers); Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden*, 67 U. CIN. L. REV. 1129, 1177-78 (1999) (describing the operation of the "disclose or abstain" rule to issuer trading transactions).

trading regulation that impacts transaction planning is the concept of materiality. Although materiality is defined using the same, well-known legal standard for many different purposes under the federal securities laws, the concept of materiality as implemented in U.S. insider trading regulation has created unique planning problems for public companies and their insiders.<sup>12</sup> This unique effect results from the fact that the judicially ordained law of insider trading in the United States acts as a transactional disclosure rule that, unlike other disclosure rules under the federal securities laws, provides issuers and their insiders with no specific disclosure content guidance. Accordingly, while corporate issuers and their directors and officers know that they cannot trade when they are in possession of material undisclosed information, the imprecise existing legal standard defining what is “material” makes it difficult for those issuers, directors and officers to understand their legal obligations.<sup>13</sup>

This Article argues, based on applicable policy and related elements of stockholder value, that issuers, insiders, and their legal advisors, as well as investors and courts, would benefit from additional guidance in making materiality determinations in the insider trading context and suggests a method for constructing that guidance. In so doing, the article does not attempt to challenge the existing scheme of regulation of insider trading, although certain of the criticisms and observations made in the article could be used to mount such a challenge. Rather, the ideas presented in this Article are designed to work within the confines of the current regulatory system to make insider trading prohibitions clearer and fairer through, among other things, the expanded use of *per se* rules, presumptions, and safe harbor provisions.<sup>14</sup>

---

11. In U.S. insider trading regulation, the term “insiders” includes an issuer’s directors and officers, but also includes others with “a relationship of trust and confidence” to the issuer’s stockholders. *Chiarella*, 445 U.S. at 230.

12. See, e.g., Bainbridge, *supra* note 1, at 1028-34 (noting that a public issuer’s determination of what constitutes material information is complicated by the notion that the value of corporate disclosure declines when the market is flooded with too much information); Bochner & Bukhari, *supra* note 10, at 228 (discussing ways in which materiality assessments as to financial results often are difficult).

13. See *supra* note 12; *infra* Part II (describing the current legal standard defining materiality and its application in the insider trading context); see generally John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41 (1998) (describing the continually evolving SEC mandatory disclosure requirements and the difficulty of determining whether a fact not mandated to be disclosed by an SEC rule is otherwise material to the total mix of information).

14. An actor’s complete compliance with all terms of a safe harbor provision ensures that the actor is protected from a violation of the legal rule as to which the safe harbor is provided. See Christopher Dean Olander & Cynthia L. Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Laws*, 45 MD. L. REV. 21, 58 n.134

## I. BACKGROUND

At the core of our nation's insider trading prohibitions is the notion that public issuers of securities and their insiders cannot trade in the issuer's securities while in possession of material nonpublic information. Accordingly, when a public issuer or one of its insiders is in possession of undisclosed material information, the issuer or insider must either disclose the material information before trading in the issuer's securities or abstain from trading in the issuer's securities.<sup>15</sup> This notion, referred to as the "disclose or abstain" rule, is based in decisional law under Section 10(b) of the 1934 Act,<sup>16</sup> and Rule 10b-5, which interprets Section 10(b). Most insider trading cases are brought under Section 10(b) and Rule 10b-5.<sup>17</sup>

---

(1986) ("By 'safe harbor,' the SEC means that if all conditions of such a rule are met, compliance with the underlying statutory exemption is assured"); *see also* BLACK'S LAW DICTIONARY 1336 (7th ed. 1999) (a safe harbor is "an area or means of protection . . . a provision (as in a statute or regulation) that affords protection from liability or penalty").

15. *See* *Chiarella v. United States*, 445 U.S. 222, 226-30 (1980) (endorsing the imposition of a corporate insider's obligation under Section 10(b) and Rule 10b-5 to disclose material nonpublic information or abstain from market transactions when in possession of such information); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc) (imposing a duty under Section 10(b) and Rule 10b-5 that anyone in possession of material inside information must either disclose it to the investing public, or abstain from trading in or recommending the securities while such information is undisclosed). In 1961, the SEC first articulated the "disclose or abstain" rule in an enforcement action against a brokerage firm and one of its partners. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *see* Nagy, *supra* note 10, at 1129 (noting the "disclose or abstain" rule was first articulated by the SEC in *Cady, Roberts & Co.* and adopted by the United States Supreme Court in *Chiarella*); Jennifer L. Neumann, *Insider Trading: Does "Aware" Really Resolve the "Possession" Versus "Use" Debate?*, 7 WASH. U. J.L. & POL'Y 189, 191 (2002). Under the facts in *Cady, Roberts & Co.*, the partner of the brokerage firm was informed by one of his colleagues (a board member of the issuer) that the issuer's board of directors had approved a reduction in the issuer's quarterly dividend. *Cady, Roberts & Co.*, 40 S.E.C. at 908. While in possession of this as-yet-undisclosed information, the partner sold shares of the issuer held in customer accounts and in trust for his children, and he sold shares short for his own account. *Id.* The SEC found facts indicating that the trading partner had violated Rule 10b-5. *Id.* at 915-17. The "disclose or abstain" rule is effectively codified in the recently adopted Rule 10b5-1 under the 1934 Act. 17 C.F.R. § 240.10b5-1(a) (2003).

16. 15 U.S.C. § 78j(b) (2003) [hereinafter Section 10(b)]. Section 10(b) provides, among other things, that a person or entity may not use interstate commerce "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." *Id.*

17. The current text of Section 10(b) expressly mentions rules promulgated under its authority to regulate insider trading (in connection with the applicability of Section 10(b) to security-based swap agreements). *See* 15 U.S.C. § 78j(b). However, it is not clear from the original text of Section 10(b) and Rule 10b-5, reproduced in pertinent part *supra* notes 7 and 16, that the provisions of either are intended to cover insider trading claims. In fact, a number of scholars note that the drafters of Section 10(b) did not intend for it to be used for insider trading claims. *See, e.g.,*



The definition of the word “material” in the context of the “disclose or abstain” rule is neither statutory nor static. Moreover, this materiality definition is not specific to insider trading regulation. Rather, the definition of the word “material” in the context of the “disclose or abstain” rule is based on a generic, judge-made legal standard applicable to materiality determinations under Rule 10b-5 and other elements of disclosure regulation under both the 1934 Act and the Securities Act of 1933, as amended (the “1933 Act”).<sup>18</sup> This broadly applicable judicial standard generally requires that a transaction planner<sup>19</sup> or court assess the likelihood that a reasonable investor (or stockholder) would consider a particular fact or particular information important in making an investment decision.<sup>20</sup> In the context of insider trading, the investment decision involves a purchase or sale of securities.<sup>21</sup> Alternatively stated, in determining

---

Michael P. Dooley, *Insider Trading: Comment From an Enforcement Perspective*, 50 CASE W. RES. L. REV. 319, 319 (1999) (“There is absolutely no evidence in the legislative history of section 10(b) or accounts of the SEC’s adoption of Rule 10b-5 eight years later that either Congress or the Commission was even thinking about insider trading as a target of the statute or the rule.”); Franklin A. Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT’L LAW. 63, 70 (2002) (asserting that the 1934 Act did not prohibit anyone from trading on inside information); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 385-86 (1990) (challenging the courts’ misconception of Section 10(b) as a whole). Since the decision of the SEC in *Cady, Roberts & Co.* and the Second Circuit’s opinion in *Texas Gulf Sulphur*, however, Section 10(b) and Rule 10b-5 have been the principal sources of insider trading regulation outside the more narrowly tailored areas of short-swing profit reporting and liability, both of which are governed by Section 16 of the 1934 Act. 15 U.S.C. § 78p (2003); see Gevurtz, *supra*, at 70-72 (providing a brief and accessible description of the use of Section 10(b) and Rule 10b-5 to regulate insider trading in the United States).

18. 15 U.S.C. §§ 77a-77aa (2003). The U.S. Supreme Court has expressly noted that materiality determinations in the context of insider trading are to be made using the same standard that is applicable in other disclosure contexts. See *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988) (finding “no authority in the statute, legislative history, or previous decisions for varying the standard of materiality”). Lower federal courts have followed this lead. See *SEC v. Hoover*, 903 F. Supp. 1135, 1148 (S.D. Tex. 1995) (holding that insider trading cases use the same standard for materiality as cases alleging a fraudulent failure to disclose on the part of a company); *Rosenfeld v. Parentcare Ltd.*, No. 91 Civ. 1956 (KTD), 1993 U.S. Dist. LEXIS 14532, \*5 (S.D.N.Y. Oct. 14, 1993) (presenting defendants’ argument that the same materiality standard applies to both Section 10(b) and Section 12 claims).

19. For purposes of this article, the term “transaction planner” includes any issuer of securities, any insiders of that issuer, and their respective advisors on any transaction at issue, including without limitation legal counsel.

20. See *Basic*, 485 U.S. at 231 (adopting the Section 14(a) standard of materiality established in *TSC Indus.* for cases brought under Section 10(b) and Rule 10b-5); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (setting forth the general standard of materiality for use under § 14(a) of the 1934 Act to include those facts that are substantially likely to be considered important by a reasonable shareholder in deciding how to vote).

21. In this respect, purchase and sale decisions under Rule 10b-5 are distinguishable from voting decisions under Section 14(a) of the 1934 Act. As the U.S. Supreme Court recognized in *Basic*, the materiality standard adopted in *TSC*

the materiality of a particular omitted fact, a transaction planner or court must assess whether there is a substantial likelihood that the omitted information would affect the “total mix” of market information available.<sup>22</sup> Accordingly, if a fact is substantially likely to be considered important to a reasonable investor in making an investment decision (or is substantially likely to affect the total mix of available market information), it is material.<sup>23</sup> A fact that is not substantially likely to be considered important to a reasonable investor in making an investment decision (or is not substantially likely to affect the total mix of available market information) is not material.<sup>24</sup>

The facial simplicity of the basic legal standard governing materiality masks the complexities encountered by transaction planners, litigants, the SEC, the U.S. Department of Justice (“DOJ”),<sup>25</sup> and courts in interpreting and applying that standard.<sup>26</sup> The

---

*Industries* is fact-sensitive, but it does not provide guidance as to whether and when a “reasonable investor” would consider a fact significant. *Basic*, 485 U.S. at 238. Thus, a reasonable investor may find different information important in the investment context than in the voting context. *See infra* note 64.

22. *See Basic*, 485 U.S. at 231-32 (quoting *TSC Indus.*, 426 U.S. at 449); *see also TSC Indus.*, 426 U.S. at 449 (concluding that, for an omitted fact to be material, “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”). The Court apparently views its two statements on the meaning of materiality (regarding investor importance and the “total mix” of market information) as alternative formulations of the same legal standard. Some subsequent courts, however, view them as separate tests or use only one of the two formulations in describing or assessing materiality. *See, e.g.*, *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1097 (1991) (referencing investor importance formulation); *SEC v. Fife*, 311 F.3d 1 (1st Cir. 2002) (referencing investor importance formulation); *Phillips v. LCI Int’l, Inc.*, 190 F.3d 609, 619 (4th Cir. 1999) (using “total mix” formulation); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1217-18 (1st Cir. 1996) (referencing “total mix” formulation); *Nappier v. Pricewaterhouse Coopers LLP*, 227 F. Supp. 2d 263, 273 n.2 (D.N.J. 2002) (referencing the investor importance formulation); *In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 150 (D. Mass. 2001) (referencing “total mix” and citing to *Shaw*).

23. *See supra* notes 20 & 22 and accompanying text.

24. *See, e.g.*, *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (holding plaintiff could not show that a one day delay in availability of funds would have been material in a decision to purchase treasury bills); *Feinmann v. Dean Witter Reynolds, Inc.*, 84 F.3d 539, 541 (2d Cir. 1996) (holding that in civil cases customers failed to show that misrepresentations of transaction fees were material to their securities transactions).

25. The U.S. Department of Justice has the power and authority to bring criminal enforcement actions on the basis of violations of Rule 10b-5, including those involving insider trading. *See* 15 U.S.C. § 78ff (2003) (providing criminal penalties for willful violations of the 1934 Act).

26. One commentator notes: “[e]ven with the benefit of the definition, disclosure decisions are arduous.” Fedders, *supra* note 13, at 44-45; *see* Glenn F. Miller, Comment, *Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality*, 95 Nw. U. L. REV. 361, 389-94 (2000) (highlighting difficulties in interpreting the standard for materiality in light of recent

interpretation and application of the materiality standard are highly fact-dependent and do not always produce predictable or certain planning options or judicial results.<sup>27</sup> Moreover, current regulatory guidance on materiality does not serve to clarify in any meaningful way the interpretation and application of the legal standard.<sup>28</sup> In the absence of better regulatory guidance, the current legal standard is inadequate for transaction planning and judicial decision-making. This current, inadequate regulatory guidance disproportionately affects the interpretation and application of Rule 10b-5 in the insider trading context because, in contrast to other areas of disclosure regulation<sup>29</sup> under the securities laws, there are no line-item disclosure obligations or specific guidelines applicable to issuers and their insiders in complying with the “disclose or abstain” rule.<sup>30</sup>

---

SEC guidance).

27. These results are memorialized in a dauntingly large, and rapidly growing, body of decisional law. Over 200 securities fraud class actions were filed in each of 1998, 1999, 2000, 2001, and 2002, many of which involve insider trading or disclosure claims that implicate materiality issues. See Stanford Law School, *Securities Class Action Clearinghouse*, at <http://securities.stanford.edu> (last modified May 31, 2003).

28. See sources cited *infra* note 32 (regarding the SEC’s failure to more clearly define materiality); see also Jason Michael Craft, *What’s All the Commotion?: An Examination of the Securities and Exchange Commission’s Regulation FD*, 14 DEPAUL BUS. L.J. 119, 156 (2001) (commenting that “[o]ne of the largest failures of Regulation FD is the SEC’s lack of any meaningful guidance or direction as to what information will be considered material”).

29. Of course, § 10(b) and Rule 10b-5 are antifraud provisions, not mandatory disclosure rules—rules that call for specific substantive disclosure based on a transactional or periodic reporting requirement. See, e.g., Regulation S-B, 17 C.F.R. pt. 228 (2003) (containing line-item disclosure rules for small business securities issuers); see *id.* pt. 229 (containing line-item disclosure rules for other securities issuers); see *id.* pt. 210 (containing specific disclosure requirements for financial statements). In the insider trading context, however, the “disclose or abstain” rule has the effect of a macro mandatory disclosure rule. The existence of a duty to disclose arising out of issuer or insider securities trading activity compels disclosure of all material nonpublic information before any trade is made. See 17 C.F.R. § 240.10b5-1 (2003) (effectively codifying the “disclose or abstain” rule). Accordingly, it is appropriate to refer to the regulation of insider trading under Rule 10b-5 as a form of disclosure regulation. See Gerla, *supra* note 10, at 116-18 (describing an issuer’s duty to disclose under Rule 10b-5 generally by reference to insider trading cases).

30. In fact, although public offerings by issuers, public offerings by insiders, and tender offers require the filing of comprehensive public disclosure documents under SEC rules and regulations, the market transaction that typically forms the basis of an insider trading violation does not trigger a disclosure document filing obligation by an issuer or insider under the federal securities laws. See Gerla, *supra* note 10, at 111-12 (noting generally an issuer’s “extensive” disclosure requirements for registered offerings and raising the question, by contrast, as to the disclosures required to be made by issuers in other contexts, where only Rule 10b-5 is operative). An insider who is an affiliate for purposes of Rule 144 under the 1933 Act, may be required to file a Form 144 with the SEC in advance of a sale of securities in order to enjoy the safe harbor protections of that Rule. See 17 C.F.R. § 230.144(a)(1) (2003); *id.* § 230.144(h) (2003). The disclosures provided on Form 144, however, relate to the

Among other things, this failure of guidance may more easily lead to allegations that there has been a failure of adequate disclosure, even with thoughtful advance planning.

In fact, the SEC, the federal regulatory agency charged with interpreting and enforcing the U.S. securities laws,<sup>31</sup> purposefully has left ambiguous the effect of applying the existing materiality standard to any specific factual situation.<sup>32</sup> The high degree of imprecision inherent in this standard not only creates legal uncertainty and headaches (sometimes nightmares) for transaction planners, litigants, enforcement agencies, and courts, but also is inessential to (and potentially distracts from) achievement of the basic policy goals underlying the regulation of insider trading under Rule 10b-5, on the one hand, and those underlying Section 10(b), Rule 10b-5, and the 1934 Act as a whole, on the other hand.<sup>33</sup> Specifically, existing ambiguities in the interpretation and application of the current materiality standard in the insider trading context are not necessary to ensure: (1) the fair and honest operation of the U.S. securities

---

insider and the proposed securities trading transaction, not the issuer. *See* SEC Form 144, *available at* 2 Fed. Sec. L. Rep. (CCH) ¶ 7411. Similarly, an insider subject to Section 16(a) of the 1934 Act may be required to report a transaction in the issuer's securities by filing a Form 4 or a Form 5 with the SEC after engaging in that transaction. *See* 17 C.F.R. § 240.16a-3(a) (2003). Again, these public filings include information about insiders and their transactions, but not comprehensive disclosure regarding the applicable issuers, attributes of their securities, or even the manner of sale by the insider.

31. The SEC was created under Section 4 of the 1934 Act. 15 U.S.C. § 78d(a) (2003).

32. *See* Selective Disclosure and Insider Trading, Release No. 34-43154, 65 Fed. Reg. 51,716, 51,721 (Aug. 24, 2000) ("While we acknowledged 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."); SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,151 (Aug. 12, 1999) (codified at 17 C.F.R. pt. 211) ("quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations"); Fedders, *supra* note 13, at 42 ("[T]he SEC stubbornly refused to promulgate rules designed to fill in the details of a broadly stated qualitative standard of materiality . . ."); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1337-38 (1999) (generally noting the SEC's failure to clarify insider trading prohibitions and specifically noting ambiguities around the "probability versus magnitude" materiality test). The reluctance of the SEC to better define materiality in the insider trading context is unremarkable when viewed in the light of Congress's reluctance to statutorily define insider trading as a whole. *See* MEREDITH M. BROWN, TAKEOVERS: A STRATEGIC GUIDE TO MERGERS AND ACQUISITIONS 157-61 (2001) (describing unsuccessful congressional efforts to define insider trading); RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL § 4.05 (2002) (noting that the 1934 Act and subsequent legislation "still [do] not contain a formal definition of insider trading prohibited by Section 10(b)"); THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 661 (4th ed. 2002).

33. *See infra* Part III.

trading markets, free from any breach of trust by issuers and their insiders; (2) the protection of investors and promotion of the integrity of U.S. securities markets through the prevention of fraud, manipulation, and deception in connection with the purchase or sale of securities; and, (3) the complete and accurate public disclosure of important information about issuers and transactions.<sup>34</sup>

Inherent ambiguities in the interpretation and application of the existing materiality standard not only are nonessential to the achievement of applicable policy goals, but also create certain undeniable negative impacts on stockholder value that may undercut those policy goals. These impacts include, among other things, foregone value-enhancing transactions (including issuer offerings and stock repurchases), management distractions, and outside counsel fees and disbursements.<sup>35</sup> Negative impacts on stockholder value might be reduced or eliminated if materiality were more precisely defined.<sup>36</sup> The negative impacts on stockholder value associated with ambiguities in the interpretation and application of the current materiality standard are not apparently outweighed by perceived benefits associated with those ambiguities.<sup>37</sup>

Moreover, it is probable that the existing legal standard for materiality enhances prospects for non-meritorious or marginal, speculative, settlement-focused, expensive, time-consuming class action litigation against issuers and their insiders, further eroding stockholder value.<sup>38</sup> Securities fraud class actions are less frequently dismissed than settled.<sup>39</sup> Those that are settled may result in high

---

34. *Id.*

35. *See infra* Part IV.

36. *See infra* note 149 (regarding the relationship among insider trading, stockholder value, and investor confidence); *see also infra* note 218 (regarding overall benefits of clarity and precision under Rule 10b-5).

37. Nevertheless, these benefits may, in some part, explain the reluctance exhibited by Congress, the courts, and the SEC to define insider trading. *See* sources cited *supra* note 32 (regarding the SEC's and Congress's reluctance to better define materiality); *see* sources cited *infra* notes 124-26 and accompanying text (regarding the possible benefits of ambiguity in statutory construction, interpretation, and application).

38. *See infra* Part V (describing the current insider trading class action environment and the need for substantive reform).

39. *See* Elaine Buckberg et al., *Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?*, at <http://www.nera.com/wwt/publications/6143.pdf>, at 6 (June 2003) (stating that 80% of federal securities class actions are settled and approximately 19% are dismissed); Lisa Klein Wager & Adrienne M. Ward, *Securities Class Actions: A Company's Bad News Gets Worse*, BUS. L. TODAY, July/Aug. 2002, at 15, 16, 18 (explaining that 24% of class actions are dismissed; 99.5% of the remainder are settled); Richard Painter et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis* 7, at <http://www.fed-soc.org/pdf/PSLRAFII.PDF> (last visited Apr. 22, 2003) (citing a 22.2% dismissal rate for 2001 and a 25.1% average dismissal rate for cases from 1996-2001);

dollar-value settlements,<sup>40</sup> paid by the issuer, that ensure to the detriment of holders of the issuer's stock at the time the settlement is paid, who or which may not be entitled to receive an offsetting portion of any settlement amounts as plaintiffs in the class action.<sup>41</sup> A significant number of securities fraud class actions include insider trading allegations.<sup>42</sup> In many insider trading actions, materiality determinations have a significant role in the case.<sup>43</sup> Where neither trading nor possession of nonpublic information is at issue, materiality becomes the key unproven element of the plaintiff's claim.<sup>44</sup> Under these circumstances, existing ambiguities in the

---

*see also* Buckberg et al., *supra*, at 5 (noting that dismissals of securities class actions have "fallen by a statistically significant measure" since the adoption of Sarbanes-Oxley).

40. Through year-end 2001, the mean and median settlement value of 303 identified settlements of securities class action complaints were \$24.9 million and \$5.5 million, respectively. *See* Stanford Law School, *Securities Class Action Clearinghouse, Post-Reform Act Securities Case Settlements*, at [http://securities.stanford.edu/Settlements/REVIEW\\_1995-2001/REVIEW\\_1995-2001.html](http://securities.stanford.edu/Settlements/REVIEW_1995-2001/REVIEW_1995-2001.html) (last modified Mar. 15, 2002); *see also* Buckberg et al., *supra* note 39, at 7 (identifying and commenting on mean and median settlement values on an annual basis from 1991 through 2002 and to date for 2003).

41. Plaintiffs in a securities fraud class action are not required to hold the issuer's securities during the pendency of the suit. *See* George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 894 (1983) (noting that securities class actions "may produce 'error costs,' such as the hindrance of capital formation, and these costs may ultimately be borne by shareholders, whom the securities laws are supposed to protect, without necessarily compensating the victims of the violation of the law."). Accordingly, they can, and sometimes do, sell their entire position in the issuer's securities before a settlement or judgment is reached in the class action. Moreover, to have standing to bring a private action under Rule 10b-5, a prospective plaintiff actually must have sold or purchased the issuer's securities. *See* *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975) (holding that for the purposes of Section 10(b) and Rule 10b-5, private damage actions are limited to purchasers and sellers of securities). Therefore, certain class action plaintiffs may have standing to sue only because they have sold off their entire positions in the issuer's securities. Under these circumstances, the selling security holders would receive their proportionate share of any class action settlement or judgment and would not be negatively impacted by any payments made by the issuer.

42. *See infra* note 206.

43. *See* sources cited *infra* note 61; *see, e.g.*, *Helwig v. Vencor, Inc.*, 251 F.3d 540, 555-56 (6th Cir. 2001); *In re Microstrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 656-58 (E.D. Va. 2000); *Blanchard v. Edgemark Fin. Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 90,439 (Feb. 3, 1999). Scier and materiality often go hand-in-hand in insider trading cases. *See* Allan Horwich, *The Neglected Relationship of Materiality and Recklessness in Actions Under Rule 10b-5*, 55 BUS. LAW. 1023 (2000) (identifying cases in which the relationship between scier and materiality is at issue).

44. In such cases, assuming the existence of standing, scier, reliance, and loss causation, materiality is the key (if not the only) element of the insider trading claim at issue in the case. When an issuer or one of its insiders purchases or sells stock in the market, any omission to state an alleged material fact known by that issuer or insider is considered to be in connection with that purchase or sale. *See* Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: the Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 182-83 (1995). Moreover, the fact that an insider has traded while in possession of

interpretation and application of the current materiality standard, combined with (arguably) plaintiff-friendly procedural aspects of class actions, act to encourage class action plaintiffs' counsel to bring suit (and defendants to settle) in circumstances where the facts raise any possibility of an insider trading violation. Given the ongoing debate around procedural reforms in the area of federal class actions,<sup>45</sup> it is time we looked to other ways of clearing court dockets of speculative insider trading class actions. Additional guidance on materiality in the context of insider trading could reduce the number or settlement value of these insider trading class actions.

In short, for a variety of reasons, it now is time for more detailed interpretive guidance on materiality in the context of U.S. insider trading regulation.<sup>46</sup> If properly crafted, this guidance would do no

---

nonpublic information may be sufficient to establish the required scienter. *See* *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197-98 (1st Cir. 1999) (discussing the evidentiary relationship between allegations of insider trading and scienter); *Rubinstein v. Collins*, 20 F.3d 160, 169 (5th Cir. 1994) ("Insider trading in suspicious amounts or at suspicious times is, of course, presumptively probative of bad faith and scienter.").

45. *See, e.g.*, Robert S. Green, *Class Action Reform Does Not Provide 'Fairness' to Anyone*, CONSUMER FIN. SERV. L. REP., Feb. 26, 2003, LEXIS, News & Business library, News Group file; Sean Higgins, *Shareholder Suits Near A High Despite '95 Reform Legislation; Dismissals Also Climb*, INVESTOR'S BUSINESS DAILY, Sept. 10, 2002, LEXIS, News & Business library, News Group file; Blair A. Nicholas, *Restoring Investor Confidence in the Securities Markets*, SAN DIEGO UNION-TRIB., July 26, 2002, at B-7. The tension in this debate, especially in the post-Enron era, is between those who argue that existing procedural rules applicable to securities fraud class actions represent an unacceptable bar to important, investor-protective class action litigation and those who contend that the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter PSLRA], did not go far enough in curbing attorney-controlled, speculative, settlement-oriented class action litigation. This same tension, albeit with different procedural focal points, framed the debate that preceded Congress's adoption of the PSLRA. Professor Jill Fisch describes these circumstances well when she writes:

The Private Securities Litigation Reform Act of 1995... reflects an innovative congressional effort to refine securities fraud class actions. In adopting the PSLRA, Congress recognized that although the class action is a valuable tool for increasing plaintiff access to the legal system, its structure presents opportunities for abuse. In particular, collective action problems and small claimant stakes limit plaintiff participation in litigation decisions. Decisions are made by entrepreneurial lawyers who effectively control the litigation. Plaintiffs' lawyers have a substantial interest in the litigation—frequently a larger interest than any individual class member. Lawyer control of class actions coupled with the potential divergence between the interests of the lawyers and those of the class creates a risk that litigation decisions will not reflect the best interests of the plaintiff class or society as a whole.

Jill E. Fisch, *Complex Litigation at the Millennium: Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 53 (2001) (footnote omitted).

46. This Article focuses on the role of materiality in U.S. insider trading regulation. With increased and highly publicized allegations of corporate fraud, which are frequently accompanied by allegations of insider trading, this focus is

violence to applicable policy and would enhance predictability and certainty in the application of Rule 10b-5 in the insider trading context. This enhanced predictability and certainty would come from the identification and analysis of key areas of disclosure in which materiality guidance should be provided and the construction of sufficiently detailed guidance in a disciplined, thorough manner based on applicable policy and existing regulatory principles.

The remainder of this Article proceeds in six additional parts, followed by a conclusion. Part II describes the current legal standard defining materiality and its application in the insider trading context, including by way of analysis of two sample fact patterns. Part III identifies key regulatory policies underlying Rule 10b-5 and the 1934 Act, in general and in the insider trading context, and shows that these policies do not dictate imprecise materiality guidelines in the insider trading context. Part IV illustrates how the lack of predictability and certainty in interpreting and applying the existing legal standard for determining materiality for insider trading purposes may impact stockholder value. Part V describes the current securities fraud class action litigation environment, both generally and as it relates to insider trading cases, and contends that ambiguities in the interpretation and application of the existing materiality standard contribute to a drain on stockholder value created by continued speculative and abusive class action litigation. Part VI suggests an approach that can be used in more precisely defining materiality in the insider trading context, consistent with applicable policy and existing regulatory principles. The suggested approach is designed to enhance predictability and certainty in the interpretation and application of the existing materiality standard,

---

warranted. See Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 298 (1999) (analyzing the relative importance of insider trading allegations and private actions after the PSLRA); see also *infra* note 206. Materiality is, however, omnipresent in the antifraud and disclosure rules under the federal securities laws, and the U.S. Supreme Court has endorsed a uniform materiality standard. See sources cited *supra* note 18. The author, therefore, acknowledges that materiality guidance in the context of U.S. insider trading regulation also would have an undeniable effect on materiality analyses under Rule 10b-5 generally and in other federal securities law disclosure contexts. See *Selective Disclosure and Insider Trading*, *supra* note 32 (noting observations about the potential effect of materiality guidance offered for a limited purpose on the overall interpretation and application of the materiality standard). Any such effect would, in the author's view, be desirable, even if the grounds for enhanced guidance in other contexts are not as compelling as those supporting enhanced guidance in the insider trading context. While the rationale for enhanced materiality guidance is most strong in the insider trading area, much of the argument set forth in this Article applies equally to other areas of antifraud and disclosure regulation under the federal securities laws, especially other areas under Rule 10b-5.



thereby reducing negative impacts and inefficiencies created by the imprecision of that standard. Part VI also provides examples that illustrate the suggested drafting approach, drawn from the fact patterns first used in Part II.

## II. MATERIALITY AND INSIDER TRADING

### A. *Two Examples; One Key Question*

The highly significant role of materiality in insider trading regulation is best understood by reference to specific facts and circumstances. Consider, as examples, the two fact patterns described below, each of which represents trading by an insider<sup>47</sup> while in possession of one or more different types of undisclosed information.<sup>48</sup>

#### 1. *Example #1—Improper balance sheet accounting*

The first example involves the exercise of employee stock options and the public sale of underlying shares of common stock of a Corporation by the Corporation's Chief Financial Officer ("CFO") at a time when the Corporation's publicly available financial statements

---

47. Although the examples posit that the trading transaction, in each case, has been effected by an insider, the examples easily could have been focused around issuer trading transactions without implicating any change in the legal analysis, since the same "disclose or abstain" rule applies to issuers and their insiders. See sources cited *supra* note 10. One might question, however, whether the legal analysis for issuers and insiders *should* be the same. See Gerla, *supra* note 10, at 118 (noting that several scholars have questioned the premise that issuers are insiders when they trade in their own securities). The impacts on stockholder value described *infra* Part IV, for example, are most compelling when the issuer, rather than an insider, engages in the subject trading transaction. In fact, insider trading legislation in a number of countries only regulates trading by insiders, not the issuer. See, e.g., Canada Corporations Act, R.S.C., ch. C-32, §§ 100(1), 100(4) (1970) (Can.) (proscribing action by an "insider," defined without reference to the issuer); Criminal Justice Act, c. 36, § 52 (1993) (Eng.) (specifying liability for "[a]n individual who has information as an insider"); Heinz-Dieter Assmann, *The United Kingdom*, in GERHARD WEGEN & HEINZ-DIETER ASSMANN, *INSIDER TRADING IN WESTERN EUROPE, CURRENT STATUS* 33, 42-43 (1994) (describing then-existing U.K. insider trading legislation); James N. Dudley & Ken Casey, *Luxembourg*, in GERHARD WEGEN & HEINZ-DIETER ASSMANN, *INSIDER TRADING IN WESTERN EUROPE, CURRENT STATUS* 171, 173-74 (1994) (describing then-existing Luxembourg insider trading legislation). Arguments for the application of different legal standards to analyses of insider trading and issuer trading, while intriguing, are beyond the scope of this Article.

48. The two examples set forth in this Part have been chosen because they represent somewhat typical fact patterns that raise interesting interpretive issues. Examples that lend themselves to a more simple analysis (i.e., where nonpublic information is certainly material or obviously immaterial) are not the subject of this article. As to these simple examples, the legal standard governing materiality does its job well enough; the lack of clarity and precision in that legal standard should not result in the transaction costs and other detriments described in this article under those circumstances.

do not fairly present the financial position of the Corporation in conformity with generally accepted accounting principles.<sup>49</sup>

The Corporation assembles and markets computer hardware and has experienced very rapid growth. Transactions in the Corporation's common stock are quoted on the NASDAQ National Market System. The Corporation's filings with the SEC indicate that an investment in its common stock carries certain identified risks, each of which is set forth in detail in these filings. The described risks include many generalized cautionary statements regarding the financial condition of the Corporation.

The Corporation misapplies an accounting rule and consequently misrepresents the adequacy of certain balance sheet reserves in its Quarterly Report on Form 10-Q for its third fiscal quarter. As is typical with Forms 10-Q, the Corporation's Form 10-Q underwent only a limited, informal review by the Corporation's independent auditors. The misrepresentations in the Form 10-Q result in the Corporation overstating its assets as shown in its Form 10-Q balance sheet by \$6.8 million, representing 2% of the Corporation's total assets. The misrepresentations are identified and corrected in connection with the Corporation's preparation of its next Annual Report on Form 10-K, as to which the Corporation's independent auditors perform a full audit review, at which time the Corporation also files an amended and restated Form 10-Q for its preceding fiscal quarter.

During the time that the Corporation's publicly disclosed assets are overstated, the Corporation's CFO, who knew, or should have known, at that time of the overstatement of the Corporation's assets, (a) exercises options for the purchase of the Corporation's common stock that had been granted to her by the Corporation and (b) sells the shares acquired upon exercise of the options in the market. The CFO files in a timely manner the required Form 144 and makes all required filings regarding the stock sale in accordance with Section 16(a) of the 1934 Act.

## 2. *Example #2—Failed merger discussions*

A second example involves securities trading by Target's directors in the public market in the wake of undisclosed discussions regarding the acquisition by Acquiror, a large, publicly traded corporation, for

---

49. The facts regarding materiality set forth in this example are based in part on the facts found by the court in *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997).

cash, of Target, an issuer with common stock traded on the New York Stock Exchange (the “NYSE”).<sup>50</sup>

In July, Acquiror offers to acquire Target at a price of \$9.50 per share. This offer follows two other undisclosed acquisition proposals made by Acquiror to Target in the preceding 18 months. After consideration of the July offer by Target’s board of directors, Target rejects the offer as unfair to Target and its stockholders. Neither Acquiror nor Target then discloses to the public either the offer or its rejection.

In mid-October of the same year, Acquiror again offers to acquire Target, this time at a price of \$10.50 per share. This revised offer represents a 79% premium over the then current closing price of Target’s common stock on the NYSE. After consideration of this revised offer by Target’s board of directors, Target again rejects as unfair Acquiror’s revised offer in late October. At this time, neither Acquiror nor Target publicly discloses the pre-July proposals, the July offer and rejection, or the October offer and rejection.

In March and April of the following year, three directors of Target acquire shares of Target in the public market. Each director makes all required filings regarding the share purchases in accordance with Section 16(a) of the 1934 Act. Late in April, after these purchases have been made, Acquiror publicly discloses the July and October offers, and Target immediately responds by publicly disclosing its rejection of the July and October offers as unfair to Target and its stockholders. The disclosures cause Target’s stock price to increase fifty percent over a two-day period (from \$6.00 per share to \$9.00 per share).

In early May, Acquiror commences an unsolicited tender offer for the shares of Target at a price of \$10.50 per share. In early June, Target announces that it has agreed to be acquired by Acquiror for

---

50. This example is based on publicly reported facts relating to premerger discussions and disclosures of Sara Lee Corporation and Chock Full O’Nuts Corporation in 1998 and 1999, resulting in the eventual acquisition of Chock Full O’Nuts by Sara Lee. See generally *Company News: Chock Full O’Nuts Agrees To Sweetened Sara Lee Offer*, N.Y. TIMES, June 9, 1999, at C4; *Company News: Sara Lee To Pursue Its Hostile Bid For Chock Full O’Nuts*, N.Y. TIMES, May 5, 1999, at C4; Edward Wyatt, *Chock Full O’Nuts Shares Bought After Merger Bid*, N.Y. TIMES, Apr. 24, 1999, at C3; *Company News: Chock Full O’Nuts Says It Rejected Offer From Sara Lee*, N.Y. TIMES, Apr. 23, 1999, at C3; James P. Miller, *Chock Full O’Nuts Executive Draws Fire For Not Disclosing Sara Lee Overtures*, WALL ST. J., Apr. 26, 1999, at B16; Schedule 13D of Sara Lee Corporation, filed Apr. 22, 1999, available at <http://www.sec.gov/Archives/edgar/data/20041/0000950172-99-00046> (last visited May 31, 2003) (disclosing, among other information, Sara Lee’s acquisition of more than five percent of a class of equity securities of the Chock Full O’ Nuts Corporation as required by 17 C.F.R. § 240.13d-1(a) (2003)).

common stock of Acquiror with a then current market value of \$11.00 per share.

### 3. *The materiality question*

Did the officer and directors who traded securities as described in the foregoing two examples conduct those trading transactions while in possession of material nonpublic information in violation of the insider trading prohibitions under Rule 10b-5? The officer and each of the directors are corporate insiders; each traded in the company's securities (each sold or bought common stock), and each had possession of nonpublic information (specifically, an undisclosed inadequacy of reserves and overstatement of assets in Example #1 and nonpublic information regarding unsolicited acquisition offers in Example #2). Accordingly, assuming satisfaction of the other elements of a Rule 10b-5 insider trading cause of action,<sup>51</sup> the determination as to whether the CFO (in example #1) and directors (in Example #2) violated Rule 10b-5 rests on an assessment of the materiality of the nonpublic information possessed by each.<sup>52</sup> The key question: what is "material?"

#### B. *The Applicable Legal Standard*

At the Hogwarts School of Witchcraft and Wizardry, a "Sorting Hat" is used to assign students to their respective rooming houses.<sup>53</sup>

---

51. Like other cases under Rule 10b-5, the elements of an insider trading claim generally are acknowledged to include: a misstatement (or an omission at a time when there exists a duty to speak) or another element of fraud or deception, materiality, scienter, causation, reliance, and damages. *SEC v. Tome*, 638 F. Supp. 596, 620 n.46 (S.D.N.Y. 1986); see Susan A. Wetzel, *New Rule 16b-3: The SEC's Attempt to Aid Insiders by Revising Rule 16b-3 is Much Ado About Nothing*, 24 OHIO N.U. L. REV. 125, 143 (1998) (listing common elements of insider trading claims). These elements are difficult to apply in the insider trading concept. See JAMES D. COX ET AL., *SECURITIES REGULATION CASES AND MATERIALS* 946 (3d ed. 2001) (arguing that this scheme is more effective for combating false publicity and other frauds that involve misrepresentation or nondisclosure). Accordingly, elements of an insider trading claim also have been described in a more tailored fashion. See *Colby v. Hologic, Inc.*, 817 F. Supp. 204, 215 (D. Mass. 1993) ("The essential elements of an insider trading claim as generally derived from *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972), include: (1) trading in securities by corporate insiders (2) while withholding material inside information (3) which they have a duty to disclose to the investor public.").

52. See sources cited *supra* notes 49 & 51 (regarding the relationship between materiality and the other necessary elements for private actions under Rule 10b-5, each of which—other than materiality—are assumed to be both existent and demonstrable in Example #1 and Example #2).

53. Readers familiar with the Harry Potter series of children's books will recognize the references in this paragraph to the Hogwarts School of Witchcraft and Wizardry and the Sorting Hat as being from that series. Except as otherwise noted, the information in the first paragraph of Part II.B is from J. K. ROWLING, *HARRY POTTER AND THE SORCERER'S STONE* 117-22 (1997).

When placed upon the head of each new Hogwarts student, the Sorting Hat shouts out the name of the house to which the student then is assigned.<sup>54</sup> The determination made by the Sorting Hat is unqualifiedly conclusive; by its own admission, the Sorting Hat has not yet been wrong.<sup>55</sup>

Materiality is the Sorting Hat embedded in many disclosure rules under the federal securities laws, including the “disclose or abstain” rule that operates in the area of securities fraud, including insider trading regulation.<sup>56</sup> Where there is a duty to disclose a material fact, whether in accordance with mandatory disclosure rules or anti-fraud rules, the materiality of that particular fact determines whether an individual or entity is obligated to disclose that fact.<sup>57</sup> Either the fact is material and must be disclosed, or it is not material and need not be disclosed.<sup>58</sup> Stated differently, where materiality is used to qualify a disclosure obligation, it is a key device that sorts information required to be disclosed from that which is not required to be disclosed.<sup>59</sup> In those circumstances, the law addresses only two options—“material” and “not material.” Unfortunately, application of the current standard for determining materiality frequently yields a third result—“possibly material.” While, perhaps, tolerable in circumstances involving the use of materiality as a disclosure determinant in

---

54. See *id.* (describing the Hat’s power to magically sort children).

55. J. K. ROWLING, *HARRY POTTER AND THE GOBLET OF FIRE* 177 (2000).

56. As the authors of one popular securities regulation casebook note:

Materiality is a controlling concept when there are allegations of fraud. While the fraud provisions of the federal securities laws do not impose a duty to disclose information simply because it is material, they do require affirmative disclosure of material information in certain circumstances. And they bar both material misstatements and half-truths whenever information is given to investors.

COX ET AL., *supra* note 51, at 39.

57. See generally *id.* at 39-40 (explaining the materiality is more critical in ambiguous disclosure decisions than in line-item disclosure for SEC filings).

58. See generally Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 732-36 (1989) (discussing the overall relationship between materiality and disclosure).

59. Note that, as a general matter, materiality is necessary, but not sufficient, as a disclosure regulator. A duty to disclose also must exist. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5.”); Donald C. Langevoort, *Corporate Accountability: Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 459 (2001) (footnote omitted) (“At least since *Chiarella v. United States*, it is clear that no duty to disclose arises simply because a trader or issuer possesses material nonpublic information.”). In the insider trading context, however, the very fact that the corporation or one of its insiders is trading in the issuer’s securities gives rise to that duty under the “disclose or abstain” rule of the *Chiarella* case. See *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (noting that the duty to disclose comes from the relationship of trust and confidence between the insiders and the issuer’s stockholders).

connection with narrowly tailored line-item disclosure obligations, this element of uncertainty is more troublesome in the insider trading context (and Rule 10b-5 disclosure cases generally) because of its wholly outcome-determinative nature.<sup>60</sup> The difference between materiality and immateriality in these cases often means the difference between liability and no liability.<sup>61</sup> If only materiality were as precise a sorting device as the Hogwarts Sorting Hat . . .

The word “material,” as used in the “disclose or abstain” rule under Rule 10b-5, is not defined in the 1934 Act or the rules and regulations under the 1934 Act.<sup>62</sup> Moreover, the SEC has adopted little in the way of guidance as to the substance of the definition.<sup>63</sup> Accordingly, the standard governing materiality largely has been left to judicial determination and interpretation. For over fourteen years, there has been a single, judicially created and construed, legal standard applicable to materiality determinations under Rule 10b-5. This materiality standard is set forth in *TSC Industries, Inc. v. Northway, Inc.*<sup>64</sup> and was explicitly held applicable to cases brought under Rule

---

60. See *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1532-33 (2d Cir. 1991) (“The central issue at trial was whether the April and October projections constituted *material* facts that had to be disclosed under the federal securities laws.”); see also sources cited *infra* note 61.

61. See Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 411 (1984) (“An insider trading case often turns on whether particular information, allegedly not generally available to the market, was material.”). Overall, the role of materiality in disclosure regulation is a large one. See Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 823 (1995) (“The important difference between materiality in the free-standing context as addressed by the Court and materiality in the disclosure and insider-trading contexts is that in the latter contexts materiality has meaning.”); Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 631 n.5 (1997) (“[M]ateriality and risk disclosure is at the heart of disclosure regulation, especially with respect to potential liability for fraud or nondisclosure.”).

62. See Kwang-Rok Kim, *The Tender Offer in Korea: An Analytic Comparison Between Korea and the United States*, 10 PAC. RIM L. & POL’Y J. 497, 531 (2001) (explaining that there is no statute defining materiality). Rule 12b-2 under the 1934 Act does define the word “material, when used to qualify a requirement for the furnishing of information as to any subject” (i.e., for the purpose of line-item mandatory disclosure rules) by reference to the materiality standard articulated in *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976). 17 C.F.R. § 240.12b-2 (2003); see *id.* § 230.405 (including an analogous definition relating to mandatory disclosure rules under the 1933 Act). The Rule 12b-2 definition does not apply to disclosures made under the insider trading “disclose or abstain” rule. *Id.* § 240.12b-2 (2002).

63. See sources cited *supra* note 32; see also *infra* note 250.

64. *TSC Indus.*, 426 U.S. at 449. *TSC Industries* was not an insider trading case brought under Rule 10b-5. Rather, the case involved a misleading proxy statement and alleged a violation of Rule 14a-9 under the 1934 Act. The ambiguities inherent in the *TSC Industries* materiality standard likely are largely responsible for the relatively effortless importation of the standard from the Rule 14a-9 context to the Rule 10b-5 context. Without the flexibility arising from these ambiguities, there would be some illogic to having the same standard for two wholly separate rules that

10b-5 in *Basic, Inc. v. Levinson*.<sup>65</sup> As defined in *TSC Industries* (and applied in *Basic*):

[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. This standard . . . does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. 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.<sup>66</sup>

In addition to expressly adopting the materiality standard set forth in the *TSC Industries* case, the *Basic* Court formulated a test for interpreting and applying this legal standard in the context of preliminary corporate merger discussions, thereby resolving a circuit split on the appropriate materiality analysis in that factual context.<sup>67</sup>

---

protect investors from fraud, manipulation, and deception in connection with two distinct types of investment decision. In the Rule 14a-9 context, stockholders are protected from fraud, manipulation, and deception in connection with a voting decision. In the Rule 10b-5 context, investors are protected from fraud, manipulation, and deception in connection with a purchase or sale of securities. 17 C.F.R. §§ 240.10b-5, 240.14a-9 (2003). That which is important to a stockholder in deciding how to vote may be very different from that which is important to an investor in deciding whether to purchase or sell.

65. See *Basic Inc. v. Levinson*, 485 U.S. 224, 224 (1988) (declaring the *TSC Industries* materiality definition the official standard for all Rule 10b-5 claims).

66. 426 U.S. at 449.

67. Prior to the advent of the *Basic* case, two principal judge-made tests had been developed and used by federal circuit courts of appeal in the context of premerger discussions: the “agreement-in-principle” test and the “probability versus magnitude” test. To this developed body of law, the federal appellate court hearing the *Basic* case added a third, new test: the “materiality by denial” test. The “agreement-in-principle” test was developed in the Third Circuit. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984). Under this test, merger discussions do not become material until an agreement-in-principle is reached by the parties as to price and transaction structure. The “probability versus magnitude” test was articulated by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 404 U.S. 1004 (1971), *Coates v. SEC*, 394 U.S. 976 (1969), and applied to preliminary merger discussions in *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976). The U.S. Supreme Court adopted this test in *Basic*. The “materiality by denial” test was formulated by the Sixth Circuit in its first decision in the *Basic* case. 786 F.2d 741, 748-49 (6th Cir. 1986). Under this test, “once a statement is made denying the existence of any [merger] discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue,” thereby merging the determination of the falsity of the disclosed information with its materiality. *Id.*

Under *Basic*, the materiality of premerger discussions is assessed based on a balancing of the probability of occurrence of the proposed merger transaction against the expected magnitude of the transaction to the issuer.<sup>68</sup> This test maybe referred to as the “probability versus magnitude” test.<sup>69</sup>

Although use of the *TSC Industries* materiality standard in Rule 10b-5 cases is well settled, its interpretation and application (both as a general matter and in specific factual scenarios) often are not clear.<sup>70</sup> Many pages of judicial and scholarly ink have been spent assessing the conceptual or contextual importance or significance of a wide variety of facts and events,<sup>71</sup> the nature of a “reasonable shareholder” or “reasonable investor,”<sup>72</sup> and the composition of a “total mix” of

---

68. 485 U.S. at 238-39.

69. See, e.g., *id.* at 239 n.16 (describing the test as the “probability/magnitude approach of *Texas Gulf Sulfur*”); see also Erin M. Hardtke, Comment: *What’s Wrong with the Safe Harbor for Forward-Looking Statements? A Call to the Securities and Exchange Commission to Reconsider Codification of the Bespeaks Caution Doctrine*, 81 MARQ. L. REV. 133, 159 (1997) (referencing “the probability versus magnitude test”); Edward A. Fallone, *The Clinton Court is Open for Business: The Business Law Jurisprudence of Justice Stephen Breyer*, 59 MO. L. REV. 857 (1994) (citing to “the ‘probability versus magnitude’ test set forth by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1998)”).

70. One scholar notes:

Ambiguous legal standards governing disclosure ensure that even honest managers will cause some fraudulent omissions. Corporate managers and their counsel assessing the “materiality” of a given fact receive little guidance from the courts. Disclosing a potential problem or opportunity may look deceptive in hindsight if the event does not come to pass, but omitting that fact will certainly look deceptive if the event does occur. The materiality requirement protects the corporation from having to disclose every potential eventuality. Materiality determinations, however, are among the most difficult faced by securities lawyers and their clients, and additional disclosures may give the corporation’s competitors important information. Disclosure errors are inevitable.

A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 936-37 (1999) (footnote omitted).

71. See, e.g., *SEC v. Mayhew*, 121 F.3d 44, 52 (2d Cir. 1997) (stating that “a major factor in determining whether information was material is the importance attached to it by those who knew about it”); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489 (9th Cir. 1974) (noting that “generally earnings projections of a company constitute a prime factor in estimating the worth of its stock, especially when made close to the end of the fiscal year” and therefore are material); *Byelick v. Vivadelli*, 79 F. Supp. 2d 610, 618 (E.D. Va. 1999) (listing “[e]xamples of events in the life of a corporation that are material and which an insider is duty-bound to disclose”).

72. See, e.g., *Pinter v. Dahl*, 486 U.S. 622, 636-39 (1988) (referencing the average small investor); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 517-18 (7th Cir. 1989) (noting that “[r]easonable investors do not want to know everything that could go wrong, without regard to probabilities; [because] that would clutter registration documents and obscure important information . . .” and implying that “professional traders and investors” may be an appropriate audience for certain corporate disclosures); *Texas Gulf Sulphur Co.*, 401 F.2d at 849 (“[S]peculators and chartists of Wall and Bay Streets are also ‘reasonable’ investors entitled to the same legal protection afforded conservative traders”); Donald C. Langevoort, *Commentary: Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 98 (1998) (stating



information,<sup>73</sup> among other things, in order to determine whether a particular fact is or was required to be disclosed.<sup>74</sup> Unfortunately, however, applicable decisional law and scholarship often do not permit a definitive determination as to the materiality of facts or events, even if recurring.<sup>75</sup> Accordingly, the widespread acceptance of the *TSC Industries* standard is of small comfort.

Attempts to more clearly define materiality for various federal securities law purposes, both before and after *Basic*, have failed.<sup>76</sup> These failures may be attributable to concerns that the task is too fact-dependent, seemingly making the job too difficult.<sup>77</sup> The failures

---

that “investors are not homogeneous”); Miller, *supra* note 26, at 384 (noting the difficult and dynamic nature of the “reasonable” investor part of the materiality standard).

73. See, e.g., *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533 (2d Cir. 1991) (exploring the meaning of the “total mix” formulation); *Wielgos*, 892 F.2d at 518 (articulating a truth-on-the-market argument for use by defendants in arguing immateriality on the basis that “the market had in its possession all significant information”); Dennis, *supra* note 61, at 419 (contending that the “efficient market model . . . quantifies the total mix concept”).

74. When a court is assessing materiality, these judgments typically are made on the basis of all information then made available to the court, including facts not in the possession of the issuer or its counsel at the time disclosure assessments are made. For example, the very fact that an insider of an issuer trades in the issuer’s securities may be seen as an indication of the materiality of undisclosed merger discussions. See *infra* notes 101-04 and accompanying text. Moreover, “[w]here appropriate, courts assessing the materiality of nonpublic information also can consider what actually transpired following disclosure.” *Hartford Fire Ins. Co. v. Federated Dep’t Stores, Inc.*, 723 F. Supp. 976, 987 (S.D.N.Y. 1989); see Daniel J. Bacastow, Comment, *Due Process and Criminal Penalties Under Rule 10b-5: The Unconstitutionality and Inefficiency of Criminal Prosecutions for Insider Trading*, 73 J. CRIM. L. & CRIMINOLOGY 96, 108 (1982) (“While courts that make the assessment [of materiality] . . . from a position of hindsight, the insider must follow this calculus without the certainty that such hindsight provides.”). But see *Reiss v. Pan Am World Airways, Inc.*, 711 F.2d 11, 13 (2d Cir. 1983) (“[H]indsight is of limited value and the fact that the ultimate disclosure of the negotiations affected stock price is not compelling.”).

75. Many commentators discount, ignore, or dispute the significance of the ambiguity of the current materiality standard, presumably because many reported cases involve unambiguously material or immaterial facts. See, e.g., Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through PreTrading Disclosure*, 71 S. CAL. L. REV. 303, 336 (1998) (“[I]n practice, lower courts have been reluctant to find information ‘material’ unless it concerns a ‘bombshell event’ . . .”); Marleen A. O’Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 364 (1989) (“To date, most insider trading cases have involved information that was clearly meaningful to the rational investor.”). A focus on reported cases ignores the reality of class action securities litigation described in greater detail in Part V—that plaintiffs frequently bring insider trading claims as nuisance suits (where the objective of the lawsuit is early, lucrative settlement, rather than vindication on the merits at trial). Accordingly, the ambiguity of the existing materiality standard should be assessed through an examination not only of reported cases but also of cases brought and dismissed or settled before or during trial.

76. See BROWN, *supra* note 32, at 157-61; see generally Anne L. Barragar, *Disclosure of Preliminary Merger Negotiations Under Rule 10b-5*, 62 WASH. L. REV. 81, 94 (1987) (noting that commentators have called for quantifiable materiality standards).

77. See Barragar, *supra* note 76, at 92, 94 (discussing various problems associated

also may result from fears that a bright-line test would result in one of at least three potentially undesirable outcomes, namely: (1) issuers and their insiders interested in trading while in possession of arguably material nonpublic information then would have a clear roadmap to trade for personal gain without liability;<sup>78</sup> (2) issuers and insiders would be discouraged from buying, holding and selling the issuer's securities;<sup>79</sup> or (3) issuers and insiders would be forced to disclose an overwhelming amount of information, much of it not important to investors.<sup>80</sup> In *Basic*, the Court rejected a bright-line test then utilized by a number of courts in assessing the materiality of premerger discussions and negotiations.<sup>81</sup> The *Basic* court scorned this bright-line test in part because it assumed investors are not intelligent or sophisticated enough to understand the subtleties of speculative disclosure regarding a possible acquisition transaction.<sup>82</sup>

---

with defining more precisely the materiality of merger negotiations).

78. This argument has been made with respect to defining insider trading generally. See generally George C. Nnona, *International Insider Trading: Reassessing the Propriety and Feasibility of the U.S. Regulatory Approach*, 27 N.C. J. INT'L L. & COM. REG. 185, 194-95 (2001) (noting that "[a]s the law currently stands, a defendant may be liable for insider trading on the basis of a transaction, the wrongfulness of which was not apparent at the time it was contemplated and executed."). This concern is understandable in that current deterrence of insider trading, even with an ambiguous, judge-made standard defining materiality, is not totally effective. See Fried, *supra* note 75, at 331-32 ("For although the penalty for violating Rule 10b-5 can be quite severe, there are many situations in which the probability of apprehension and punishment is very low.").

79. The reasoning of those who may have this concern likely is focused on unease about the potential materiality threshold resulting from application of any bright-line test. The argument here is that Congress, the SEC, or the courts would adopt a bright-line test for materiality in the insider trading context that is over-inclusive, effectively making illiquid any insider holdings in an issuer's securities (since the issuer is unlikely to volunteer disclosure of all material information at all times, especially under that rule). Interestingly, however, application of the existing formulations of the materiality standard may have the same effect for those officers and directors that are conservative decision makers. These insiders may decide, for example, that they would prefer not to hold the issuer's securities if they cannot buy and sell those securities relatively freely. See O'Connor, *supra* note 75, at 365-66 ("Like any general standard, the absence of precise contours . . . will deter lawful as well as unlawful behavior."); Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 413 (1991) ("Legal sanctions are imprecise, and any effort to prevent insiders from buying stock on the basis of inside information risks discouraging insiders from buying stock at all."); see also *infra* note 105.

80. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231, 233 (1988) (referencing the *TSC Industries* opinion, 426 U.S. at 448-49, which asserted that a low materiality threshold would cause issuers "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making.").

81. See *id.* at 233-37 (explaining that the test determined merger negotiations to be material only when there had been an agreement in principle as to price and structure).

82. See *id.* at 234 ("The agreement-in-principle test assumes investors are nitwits . . . unable to appreciate that mergers are risky propositions up until the closing.").

Most recently, a task force of the Section of Business Law Committee on Federal Regulation of Securities of the American Bar Association has recommended a more rigorous approach to the concept of materiality in the context of Regulation FD.<sup>83</sup> The task force notes:

The concept of materiality may be too blunt and imprecise a standard to trigger affirmative disclosure obligations . . . . At the same time that uncertainties regarding materiality can reduce the flow of information, at least as to quality, they can lead to a profusion of detail, which can obfuscate and confuse, rather than inform, the investing public. Disclosure is most helpful to the investing public when it is focused, understandable and easily accessible.<sup>84</sup>

In two recent pronouncements, the SEC has explicitly avoided adoption of a more precise definition of materiality in its rule-making and public guidance. In fact, both the promulgating release for Regulation FD (and Rules 10b5-1 and 10b5-2), published in August 2000,<sup>85</sup> and SEC Staff Accounting Bulletin No. 99, released in August 1999,<sup>86</sup> expressly reaffirm (in the context of selective and financial disclosure, respectively) the continued applicability of the existing, imprecise, *TSC Industries* standard defining materiality. Additionally, the SEC declined to offer sufficient guidance as to what is and is not material under Rule 10b-5.<sup>87</sup> In the Regulation FD release, the SEC

---

83. 17 C.F.R. 243.100-243.103 (2002); see *American Bar Association Section of Business Law Committee on Federal Regulation of Securities Report on Regulation FD*, THE SEC. REP., Spring 2002, 11, 14, at [http://www.abanet.org/buslaw/fedsec/sec\\_reporter/sec7-1.pdf](http://www.abanet.org/buslaw/fedsec/sec_reporter/sec7-1.pdf) (proposing and analyzing possible alternative approaches to a more precise definition of materiality for use in making determinations under Regulation FD) [hereinafter *Reg. FD Report*]; see also Selective Disclosure and Insider Trading, Release No. 34-43154, 65 Fed. Reg. 51716, 51721 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249) (noting the pitfalls of selective disclosure but rejecting the adoption of a bright-line test for materiality); John Tishbi, Comment, *Regulation FD: The Year That Passed and the Years Ahead*, 35 LOY. L.A. L. REV. 1131, 1140 (2002) (presenting various criticisms of the SEC's use of the existing common law standard for materiality, as supplemented by a non-exclusive list of information that may be material, as noted *infra* note 250).

84. *Reg. FD Report*, *supra* note 83, at 14; see Anthony T. Horgan, Comment, *Regulation FD Provides Firm Footing on Selective Disclosure High Wire*, 46 VILL. L. REV. 645, 656 n.71 (2001) (sampling and characterizing comments on proposed Regulation FD).

85. Release No. 34-43154, 65 Fed. Reg. 51,716 (Aug. 24, 2000).

86. 64 Fed. Reg. 45,150 (Aug. 19, 1999); see Miller, *supra* note 26 (providing an interesting description and critique of this Bulletin). A Staff Accounting Bulletin ("SAB") reflects the views held by the staff of the SEC regarding the disclosure of accounting-related practices.

87. See sources cited *supra* notes 85-86. In both the Staff Accounting Bulletin and its release on Regulation FD, the SEC does list types of information that may help determine materiality, but neither the bulletin nor the release goes further than that in giving materiality guidance. See 65 Fed. Reg. at 51,721 (Aug. 24, 2000); 64 Fed.

reasoned that the materiality standards set forth in the applicable decisional law “encompass the necessary flexibility to fit the circumstances of each case,”<sup>88</sup> and any bright-line rule “must necessarily be over- or under-inclusive.”<sup>89</sup>

### C. *Materiality Analysis in Insider Trading Cases*

The concept of materiality is critically important to insider trading analysis because undisclosed information always exists and securities trading by an issuer or one of its insiders triggers a duty to disclose.<sup>90</sup> When a corporate issuer desires to proceed with a transaction in the issuer’s securities, the issuer’s board of directors must identify the nonpublic facts in the issuer’s possession, determine the materiality or immateriality of those facts, and consider the potential effects (positive or negative) of the possible public disclosure of those facts that are material.<sup>91</sup> Based on this process of identification and consideration, the issuer can determine whether the desired securities trading transaction requires disclosure of any facts then in its possession, and, if so, whether it is willing or able to disclose those facts and proceed with the transaction.<sup>92</sup> The concept of materiality is undeniably significant in the issuer’s analysis.<sup>93</sup> When an insider desires to proceed with a transaction in the issuer’s securities, the insider must identify the nonpublic facts in the insider’s possession and determine their materiality or immateriality.<sup>94</sup> If the insider determines that the undisclosed facts then in the insider’s possession are material, absent cooperation from the issuer in the transaction,

---

Reg. at 45, 150 (Aug. 19, 1999); *see also infra* note 250.

88. *See* 65 Fed. Reg. at 51, 721 (Aug. 24, 2000) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988)).

89. *See id.*; *see also* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 565 (1992) (referencing the “familiar suggestion that rules tend to be over- and under-inclusive relative to standards”). One might argue that this deference to the judicial standard in determining materiality is part of a strategy employed by the SEC to enhance its own power by preserving enforcement and rule-making flexibility. *See* Brett H. McDonnell, *Getting Stuck Between Bottom and Top: State Competition for Corporate Charters in the Presence of Network Effects*, 31 HOFSTRA L. REV. 681, 698 (2003) (noting that the SEC generally may behave in this manner).

90. *See* sources cited *supra* notes 59 (regarding the duty to disclose) & 61 (regarding the importance of the concept of materiality to insider trading analysis).

91. *See* sources cited *supra* note 70 (commenting on the management decision process in this context).

92. *See id.*; *see also* sources cited *infra* note 105 and accompanying text (discussing the relative inability of insiders to trade securities given the omnipresence of material, nonpublic facts).

93. *See* sources cited *supra* note 61 (emphasizing the importance of the concept of materiality in disclosure regulation).

94. *See generally* Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984) (describing different approaches to ascertaining property rights in corporate information).

the insider must forego the transaction.<sup>95</sup> The nonpublic information at issue is not the insider's to disclose; the issuer has paramount rights and interests in regulating its disclosure.<sup>96</sup> Accordingly, the concept of materiality is critically important to the insider's *ex ante* transaction analysis.

But that is not all. Issuers and insiders must contend with materiality case law that creates an unfavorable environment for potential and actual defendants in the insider trading context. A key Rule 10b-5 insider trading case that addressed issues of materiality is *SEC v. Texas Gulf Sulphur Co.*<sup>97</sup> The *Texas Gulf Sulphur* opinion includes a frequently cited discussion of the appropriate legal standard applicable to materiality determinations in insider trading cases.<sup>98</sup> While the materiality standard chosen by the Second Circuit in *Texas Gulf Sulphur* was later supplanted by the existing standard adopted by the Supreme Court in *TSC Industries* and *Basic*,<sup>99</sup> the *Texas Gulf Sulphur* court makes a number of provocative observations about materiality that expressly or implicitly survive *TSC Industries* and *Basic*.<sup>100</sup> Two are particularly relevant here.

---

95. See sources cited *infra* note 105 (discussing an insider's limited ability to sell securities in this context).

96. See, e.g., *Freeman v. Decio*, 584 F.2d 186, 194 (7th Cir. 1978) (discussing situations in which an issuer has an interest in keeping nonpublic information private or in regulating its disclosure); *Conduis v. Howard Sav. Bank*, 781 F. Supp. 1052, 1057 (D.N.J. 1992) (describing information as one of a corporation's most valuable assets); Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1161 (1996) (noting the need for directors to manage information assets for the benefit of stockholders where stockholders are engaging in decision making); A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 28-29 (1998) (highlighting the duty of the insider to protect the confidentiality of the issuer's information).

97. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied sub nom.* *Coates v. SEC*, 394 U.S. 976 (1969).

98. See *id.* at 849-50 (stating that a fact is material if it reasonably might affect the value of the issuer's securities and asserting that whether facts are material within Rule 10b-5 depends upon a "balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event").

99. Specifically, *TSC Industries* and *Basic* reject the notion that a fact is material if it reasonably and objectively *might* affect the value of the issuer's securities because that formulation sets the standard for materiality too low and may subject the corporation and its managers to liability for insignificant omissions. *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Rather, the current legal standard for materiality under Rule 10b-5 relies on whether it is substantially likely that the fact *would* be important to a reasonable investor. See *Basic*, 485 U.S. at 231 (adopting the *TSC Industries* standard for materiality).

100. For example, the probability versus magnitude test adopted in the *Basic* case is directly attributed to the *Texas Gulf Sulphur* court. See *Basic*, 485 U.S. at 238-39 (citing to the *Texas Gulf Sulphur* and according deference to the endorsement of the test by the SEC).

One of the most interesting issues discussed in the *Texas Gulf Sulphur* case is whether the fact of an insider's trade can be used as evidence of the materiality of the nonpublic information possessed by that insider.<sup>101</sup> A number of courts allow the fact of a trade by an insider to be used as evidence of materiality in Rule 10b-5 actions against issuers,<sup>102</sup> including the Supreme Court in *Basic*.<sup>103</sup> In the classical insider trading setting, this practice obviates the requirement that materiality be proven separate and apart from the fact of a trade.<sup>104</sup> Moreover, this judicial practice makes it impossible for a transaction planner to give advice on materiality, except to say: "just don't trade."<sup>105</sup> If this advice were the intended effect of U.S. insider trading regulation, one would think the law would be expressly stated in these terms.

A second important aspect of the *Texas Gulf Sulphur* case that bears on materiality analysis in insider trading cases is *Texas Gulf Sulphur's* invocation of a so-called "market effect" test as a means of determining materiality.<sup>106</sup> Under this test, a determination as to the materiality of information is made based on whether that information is "reasonably certain to have a substantial effect on the market price of the security."<sup>107</sup> The "market effect" test was not endorsed by the

---

101. 401 F.2d at 851.

102. See, e.g., *Abromson v. Am. Pac. Corp.*, 114 F.3d 898, 903 n.3 (9th Cir. 1997) (qualifying the presence of insider sales as, at most, probative of materiality); *Halye v. The Lamson & Sessions Co.*, 752 F. Supp. 822, 826 (N.D. Ohio 1990) (citing *Basic* and noting insider trading during the relevant class period); Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, 74 TUL. L. REV. 883, 921-22 (2000) (explaining that trading by insiders can be probative of materiality since it may be a manifestation of an insider's assessment of nonpublic information).

103. See *Basic*, 485 U.S. at 240 n.18 (recognizing that trading by insiders may be one indication of materiality).

104. Although this practice typically is observed by courts adjudicating corporate disclosure claims, it may indicate a predisposition to finding materiality in cases raising insider trading claims (especially when those claims accompany claims of corporate nondisclosure or misstatements).

105. See Kitch, *supra* note 61, at 876 (arguing that there will never be a time when an insider is not in possession of information that a reasonable investor would consider important, thereby in effect prohibiting such key personnel from ever trading). Moreover, in light of insider trading allegations in connection with recent public reports of corporate fraud, some have suggested that corporate management should be prohibited from selling stock altogether. See Pearl Meyer, *Should Directors Ever Sell? Director Accountability; Should Law Forbid Corporate Directors From Selling Company Stock?; Panel Discussion*, DIRECTORS & BOARDS, June 22, 2002, at 15, LEXIS, News & Business Library, News Group File (discussing the benefits and dangers of prohibiting directors from selling their shares during their board terms).

106. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (remarking that a company drilling activity was too remote in time and place to have had any significant market impact).

107. See *id.* at 848 (quoting Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965)). Versions of this test are widely used in insider trading regulation outside the

Supreme Court in the *Basic* case, and it has not been endorsed by the Supreme Court since that time.<sup>108</sup> Accordingly, it is difficult to predict with certainty how much of this test may survive scrutiny in a decision made at that high a level of judicial review.<sup>109</sup> However, the “market effect” test continues to be used to some extent by lower courts, at least as a component in their materiality analyses.<sup>110</sup>

---

United States. *See, e.g.*, Financial Services Reform Act, 2001, pt. 1 § 1042A (Austl.) (covering “information [that is] not generally available,” where “if the information were generally available, a reasonable person would expect it to have a material effect on the price or value” of securities); Canada Corporations Act, R.S.C., c. C-32, § 100.4(1) (1970) (Can.) (covering “confidential information . . . that, if generally known, might reasonably be expected to affect materially the value of the securities”); Companies Act, pt. V, § 108(2)(a) (1990) (Ir.) (covering “information that . . . is not generally available, but, if it were, would be likely materially to affect the price of . . . securities”); Criminal Justice Act, 1993, c. 36, pt. V, § 52 (1993) (Eng.) (covering “securities that are price-affected securities in relation to the information”).

108. In fact, “[t]he Supreme Court . . . has refused to endorse the idea that different standards of materiality should apply when insider trading is involved.” Theresa A. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218, at 1244 n.131 (1987); *see* sources cited *supra* note 18.

109. What we do know is well summarized by Professor Gabaldon in an article released close in time to the release of the *Basic* decision:

The main problem with the ‘market effect’ test inheres in the argument that lack of market effect does not necessarily establish lack of importance. The test, therefore, is not necessarily compatible with the Supreme Court’s primary test of materiality. Even though lack of effect on price may not be definitive proof of lack of importance, however, it is safe to say that if a fact, when disclosed, would be substantially likely to affect market price, its significance to reasonable investors (and thus its materiality) is conclusively demonstrated. In other words, facts that satisfy the “market effect” test are a subset of all material facts. Accordingly, the “market effect” test may be regarded as a useful tool for proving, if not for disproving, materiality.

Gabaldon, *supra* note 108, at 1244-45 (footnote omitted).

110. *See, e.g.*, No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 935 n.13 and accompanying text (9th Cir. 2003) (noting the market effect of disclosure in its materiality analysis); *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (describing and emphasizing the role of the market effect on the stock price by the company’s disclosure in materiality analysis); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1987) (declaring that “[b]ecause the market for BCF stock was ‘efficient’ and because the July 29 disclosure had no effect on BCF’s price, it follows that the information disclosed on September 20 was immaterial as a matter of law.”); *Geiger v. Solomon-Page Group, Ltd.*, 933 F. Supp. 1180, 1188 (S.D.N.Y. 1996) (“Evidence of stock price movement may be relevant to the issue of materiality but it is not determinative.”); *Simon v. Am. Power Conversion Corp.*, 945 F. Supp. 416, 424 (D.R.I. 1996) (viewing a negative reaction by the stock price as indicative of materiality). One attorney noted in his argument at the District Court level:

I don’t want to beat a dead horse, but I believe Bloomberg, Dow Jones and the Wall Street Journal constitute a good surrogate for reasonable investors. They all picked this up as headline news and the market reacted. So, I don’t believe that we can find that this matter is dismissible on materiality grounds on a motion to dismiss.

*Buxbaum v. Deutsche Bank A.G.*, Fed. Sec. L. Rep. (CCH) ¶ 90,969 (S.D.N.Y. Mar. 7, 2000). The SEC has argued for use of the “market reaction” test in the years since

Indeed, the test may most frequently be used in insider trading cases,<sup>111</sup> where hindsight may be 20/20 vision but *ex ante* determinations may be uncomfortable at best. The possible use of the “market effect” test in the *ex ante* analysis and *ex post* evaluation of materiality is problematic for issuers and insiders, as well as judges.<sup>112</sup>

Precision and clarity on materiality are extremely important to disclosure regulation inquiries, especially those under Rule 10b-5 and other antifraud rules.<sup>113</sup> However, dependence on materiality analysis is nowhere more significant than in the insider trading context. Regardless of whether an insider’s trade or a market reaction is or will be evidence of the materiality of any nonpublic information then in the insider’s possession, materiality is a crucial issue—perhaps the only issue—in a case where a trade by that insider can be proven.<sup>114</sup> The critical nature of materiality in insider trading analysis is strong incentive to proceed toward greater precision and clarity in defining what is “material” in the insider trading context.<sup>115</sup>

---

the *Basic* case was decided. See *Hoover*, 903 F. Supp. at 1146-47 (describing the SEC’s argument that a market reaction to subsequent disclosures reflects materiality).

111. Gabaldon, *supra* note 108, at 1244 n.131.

112. *Ex ante* determinations are “based on assumption and prediction.” BLACK’S LAW DICTIONARY 582 (7th ed. 1999). On the other hand, *ex post* determinations are “retrospective” and “based on knowledge and fact.” *Id.* at 601.

113. See *id.* at 1240 (providing an overview of the concept of materiality as limiting the reach of certain disclosure obligations under the 1933 Act and the 1934 Act); see also sources cited *supra* note 61.

114. See sources cited *supra* note 61 (including citations regarding the importance of materiality in insider trading cases). Further complicating the matter is the fact that, because historic information about the issuer likely has been or will be disclosed in periodic reports, nonpublic information in the insider trading setting is likely to be speculative (uncertainty about a possible future event), forward-looking, or soft (opinions, estimates, projections) information, not historic or otherwise definitive data or information. Although the *Basic* Court specifically limited its ruling to the merger negotiation context, see *Basic Inc. v. Levinson*, 485 U.S. 224, 232 n.9 (1988) (declining to address any other kinds of contingent or speculative information), many lower federal courts use the *Basic* “probability versus magnitude” test to determine the materiality of speculative information, even in factual circumstances not involving premerger discussions or negotiations. See, e.g., *In re Rockefeller Ctr. Prop., Inc.*, 184 F.3d 280, 294 (3d Cir. 1999) (citing to *Basic* for the proposition that “[m]ateriality of contingent or speculative information or events depends on ‘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.’”); *SEC v. Fehn*, 97 F.3d 1276, 1291 (9th Cir. 1996) (citing to *Basic* for the same proposition); *Gay v. Axline*, No. 93-1491, 1994 U.S. App. LEXIS 8989, at \*17 (1st Cir. Apr. 26, 1994) (stating that “[w]e further have recognized that if an alleged omission involves ‘speculative judgments about future events,’ . . . materiality will depend 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’”); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 517-18 (7th Cir. 1989) (stating generally that “[m]ateriality depends not only on the magnitude of an effect but also on its probability.”).

115. See *Fried*, *supra* note 75, at 340 (contending that, with a lower materiality standard, “there would be less trading on inside information”).



*D. Inconclusive Answers*

The foregoing description of materiality in the insider trading context would not be complete without an analysis of the materiality of the nonpublic information possessed by the insiders in our two examples. Yet, in spite of relatively simple facts, application of the *TSC Industries* materiality standard to the two examples set forth in Section A of this Part proves to be a somewhat difficult assignment. Results obtained from that application of law to facts are not certain enough to make transaction planners, litigants, enforcement agencies, and courts comfortable about materiality determinations; whether made *ex ante* or *ex post*.

1. *Example #1—Improper balance sheet accounting*

In Example #1, a corporate officer, the CFO, sells the Corporation stock at a time when she may have been in possession of nonpublic information about the Corporation's financial statement misrepresentation. The application of the *TSC Industries* materiality standard to the Corporation's misrepresentations regarding the adequacy of its reserves (and the corresponding overstatement of its assets) described in Example #1 raises some interesting questions. Is it substantially likely that a reasonable investor would find it important to know about a misstatement of reserves that results in a two percent overstatement of total assets in making an investment decision about the Corporation's securities? Is it substantially likely that a reasonable investor would view information relating to the Corporation's misstatement of reserves that results in a two percent overstatement of total assets as significantly altering the "total mix" of information available? On the one hand, the "reasonable investor" in an immediate post-Enron market is likely to be quite sensitive to asset overstatements accompanied by executive stock trades.<sup>116</sup> On the

---

116. The facts regarding Enron's reported corporate fraud involve, among other things, an understatement of liabilities associated with off-balance sheet accounting. See Robert R. Keatinge, *Multidimensional Practice in a World of Inevitable Ignorance: MDP, MJP, and Ancillary Business after Enron*, 44 ARIZ. L. REV. 717, 718 (2002) (positing that "[a]t the risk of oversimplifying a complex set of circumstances, Enron used certain foreign partnerships to take liabilities off of its balance sheet."); David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. 890, 895 (2002); Lisa H. Nicholson, *A Hobson's Choice For Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 96 n.18 (2002). Moreover, allegations of insider trading by former Enron executives and others have accompanied the public reports of Enron's corporate fraud. See Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 171 (2002) (indicating, generally, the possibility of insider trading violations by Enron executives among others); Peter Elkind & Bethany McLean, *The*

other hand, the Corporation in Example #1 is no Enron. The financial impact of the Corporation's misrepresentations is quantitatively relatively small, as a percentage of the Corporation's total assets, and was rapidly corrected in connection with the Corporation's preparation and filing of its next periodic report under the 1934 Act. Moreover, the Corporation had outlined in its public filings certain generalized financial risks of investment.<sup>117</sup> The Corporation's misrepresentation of its reserves, and the related asset overstatement was caused by the misapplication of accounting rules, not (apparently) by an aggressive, strategic, goal-oriented use of accounting rules. So, perhaps the misstatement is immaterial . . .

But . . . perhaps not. SEC Staff Accounting Bulletin No. 99 instructs against exclusive reliance upon quantitative measures in determining materiality;<sup>118</sup> but does it not seem rational that there is some level of financial impact that is so *de minimis* as to be immaterial—or at least presumptively immaterial? Is there not some threshold level of financial impact at which we are comfortable presuming or declaring nonpublic facts to be material? Absent decisional law that is determinative (or at least highly instructive) as to the answers to these questions,<sup>119</sup> one cannot say that any particular threshold has any particular significance. To what extent (if at all), then, can a transaction planner rely on a good faith judgment that known, undisclosed facts are immaterial in weighing the risks of proceeding with a desired securities transaction?<sup>120</sup> Although the

---

*Feds Close In on Enron*, FORTUNE, Sept. 2, 2002, at 36 (noting that investigators may be interested in possible insider trading violations in connection with corporate fraud at Enron); Reuters, *Enron Probe Likely to Expand*, L.A. TIMES, Jan. 1, 2003, at 3 (reporting that “[i]nvestigators were said to be burrowing into Enron's ill-fated broadband venture, while still scrutinizing murky off-balance-sheet deals and insider trading allegations.”).

117. Such warnings give rise to a possible argument that the Corporation's public filings “bespoke caution” to an extent that the misstatements are not material. See generally *Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994) (describing the “bespeaks caution” doctrine); *In re Trump Castle Sec. Litig.*, 7 F.3d 357, 371-73 (3d Cir. 1993) (same).

118. See Securities and Exchange Commission Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150-01 (Aug. 19, 1999) (codified at 17 C.F.R. pt. 211) (expressing the view that financial misstatements are not immaterial simply because they fall beneath a numerical threshold).

119. Decisional law in this area tends to focus on both the misrepresentation of financial fact and the circumstances surrounding the financial misstatement. See *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 163-64 (2d Cir. 2000) (describing the role of numerical benchmarks in determining materiality); *Blatt v. Muse Techs., Inc.*, Nos. Civ. A. 01-11010-DPW, Civ. A. 01-12173-DPW, 2002 WL 31107537, \*8 (D. Mass. Aug. 27, 2002) (indicating that context may be relevant to determining materiality of financial misstatements, and citing, *inter alia*, *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 547 (8th Cir. 1997), on which certain of the facts in Example #1 are based).

120. In a subsequent proceeding questioning the legality of a trading transaction

facts of Example #1 are relatively simple, the analysis is not as simple as one might believe it should be, and the conclusion is uncertain.<sup>121</sup>

2. *Example #2—Failed merger discussions*

In Example #2, directors of the Target buy the Target's shares while they are in possession of nonpublic information about previous offers and premerger discussions regarding the possible sale of Target to Acquiror. Example #2 is a more complex example to analyze than Example #1. The facts apparently do not allow for the use of a compelling quantitative analysis or other simple application of the relevant legal principles. In assessing materiality, one first faces the task of determining the appropriate formulation of the materiality standard to apply to these facts. The facts of Example #2 indicate that the directors bought the Target's securities in March or April after the Board had last rejected Acquiror's offer for Target in October. In March and April, were those October merger discussions with the Acquiror still speculative information about a potential merger (in which case the "probability versus magnitude" formulation from *Basic* would apply) or has enough time passed by March or April that the fact of the October merger discussions is historical information calling for the application of one of the two

---

made on the basis of that kind of good faith determination, scienter may be questionable. *See infra* note 121. Apart from this effect, the good faith nature of the determination, however, does not help the issuer or insider in the area of materiality, since materiality analysis focuses on an objective test—the importance of the undisclosed information to the reasonable investor. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (articulating the test for materiality). Under this standard, which focuses on the reasonable investor (rather than the actual investor in any specific cause of action), the good faith of an individual issuer or insider in determining to trade while in possession of nonpublic information is likely to be deemed irrelevant.

121. Among other things, Example #1 raises questions about the relationship between materiality and scienter, the requisite state of mind of the alleged insider trader. If the CFO actually knew about the Corporation's asset overstatement (and accompanying reserve understatement) prior to selling the shares, then the CFO may be deemed to have had the requisite intent, at least to the extent needed to survive a motion to dismiss or for summary judgment. *See, e.g., Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197-98 (1st Cir. 1999) (stating that "allegations of unusual insider trading by a defendant with access to material non-public information can support a strong inference of scienter"); Rubinstein, 20 F.3d at 169 (positing that pleading requirements for scienter may be met by allegations and factual evidence of unusual trading while in possession of significant nonpublic information). All that is at issue, then, is the materiality of the known misstatements. If, however, the CFO traded in reckless disregard of the existence of the misstatements, her intent or state of mind in trading is less clear. *See In re Initial Public Offering Litig.*, 241 F. Supp. 2d 281, 365 n.111 (S.D.N.Y. 2003) (discussing the "reckless disregard" standard in insider trading cases). Among other things, the CFO would not have been on notice to evaluate the materiality of the misstatements. Under these circumstances, any materiality guidance only would be relevant to *ex post* judicial determinations.

alternative formulations of the *TSC Industries* standard? It is hard to say. Of course, the two formulations of the *TSC Industries* standard and the *Basic* “probability versus magnitude” test are intended to provide the same result in materiality determinations based on the same facts. The application and interpretation of the standards and test may, however, yield different results, principally because each focuses attention on different facts or different factual contexts.

Under the “probability versus magnitude” test, absent facts unknown to us indicating that the Acquiror still is interested in pursuing an acquisition of Target in March and April, a merger of Acquiror and Target intuitively has a low probability of occurring, even though a merger is of the highest magnitude to Target. Information about the offers or discussions regarding a possible merger of Acquiror and Target (given that the Target had rejected the Acquiror’s last offer over five months earlier) may seem too speculative to disclose and, therefore, not material.

If we apply the *TSC Industries* alternative formulations, our questions become whether there is a substantial likelihood (a) that a reasonable investor would find information about the earlier premerger discussions important in deciding whether to sell Target’s securities or (b) that a reasonable investor would view that information about the earlier premerger discussions as significantly altering the “total mix” of information about Target then available in the market. Given (for example) that Acquiror’s overtures were at significant premiums to then existing market prices for Target’s common stock, one could (but need not) conclude that there is a substantial likelihood that a reasonable investor would find information regarding the earlier merger discussions with Acquiror important. Acquiror’s valuation of Target may, for example, be a truer indicator of firm value than the market capitalization of Target. Moreover, one could (but need not) conclude that there is a substantial likelihood that a reasonable investor would view information about the earlier merger discussions as significantly altering the “total mix” of information about Target available in the market. Based on the market’s reaction to the information (once disclosed), and assuming no other information or events then impacting the Target’s market price for the securities,<sup>122</sup> it seems clear that the market did not know or had not absorbed all of the facts

---

122. See sources cited *supra* notes 106-11 and accompanying text (describing the “market effect” test as a means of assessing materiality).

regarding Acquiror's overtures. Still, the materiality determination is inconclusive based on the *TSC Industries* standard.

3. *An important, albeit limited, analytical role for decisional law*

Any attempt to definitively settle the materiality questions posed in Example #1 and Example #2 would involve a thorough canvassing of existing decisional law in an effort to find analogous (or otherwise instructive) cases. Because cases are fact-specific, a conclusive determination regarding materiality only can be made if one locates a case completely on point with the fact scenario in the case being analyzed. While occasionally (and luckily) a case on point can be located, it is a relatively rare occurrence. Even an exhausting and exhaustive search for decisional law may not yield a case or group of cases affording a clear answer.<sup>123</sup> Given the obvious inefficiencies of this process, there must be a better way . . .

E. *Why Ambiguity Matters*

The reader may now say: "Okay, okay. So, the existing legal standard defining materiality for use in the insider trading context is ambiguous; but why should I care? Why not just leave things the way they are?" Perhaps the reader even realizes that there can be advantages to ambiguity in legal standards. Truly, ambiguity in a substantive statutory or regulatory provision can be a valuable tool if used in an appropriate manner to advance an underlying policy goal.<sup>124</sup> For example, ambiguity allows for more facile development of

---

123. For instance, in the case of Example #2, decisional law research would lead us principally to a few federal judicial opinions in post-*Basic* cases that were decided on pretrial motions. In each case, the court found that information regarding the existence of premerger discussions up to and including approximately two years before a securities trading transaction affected by an insider was not immaterial as a matter of law. See *Levinson v. Basic Inc.*, 871 F.2d 562, 563 (6th Cir. 1989) (asserting that merger discussions undertaken over a two-year period may be material); see also *Caruso v. Metex Corp.*, No. CV 89-0571, 1992 WL 237299, \*8 (E.D.N.Y. July 30, 1992) (maintaining that information regarding buyout a proposal may be material two years later); *Salit v. The Stanley Works*, 802 F. Supp. 728, 732 (D. Conn. 1992) (indicating that meetings regarding a possible merger that occur less than two years before release of a subject proxy statement may be material in an action under Rule 14a-9 under the 1934 Act); *Ross v. A.H. Robins*, 465 F. Supp. 904, 908 (S.D.N.Y. 1979), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979) (finding that "[n]o general rule of time can be applied to all circumstances;" therefore, information in a four-year-old annual report may still be material and subject to a duty to correct). These opinions do not give us our answer, although they put us on notice that information regarding the earlier premerger discussions between Acquiror and Target may be material.

124. *But see Fedders*, *supra* note 13, at 87 (arguing, with respect to the federal securities laws, that "the Commission must avail every opportunity to specify what conduct is illegal [and] . . . should be unwilling to establish new rules through enforcement action, and should always expose its new theories through

and adjustments in legal rules among the three branches of government and maintenance of a “political equilibrium between the judicial and legislative branches.”<sup>125</sup> Moreover, ambiguity can have a deterrent value in that it may force potential violators to assess their behavior on a conservative basis in order to avoid liability.<sup>126</sup> Encouraging that kind of conservatism could be one desirable effect of the ambiguity in the meaning of the term “material” in the context of the “disclose or abstain” rule, if it advances an applicable statutory or regulatory objective.

However, in order to assess the effect of ambiguity on a statutory or regulatory regime, one must assess the ambiguity in its overall context and, in judging its relative merit as a legal device, balance any positive impact of the ambiguity against its undesirable effects.<sup>127</sup> For example, issuers and insiders may decide to take risks in their securities trading transactions because the lack of clarity and precision in insider trading law, including the concept of materiality, lessens the risk of being caught and found liable.<sup>128</sup> There may be

---

rulemaking”). A search for the meaning of ambiguity in a legal test necessarily invokes the debate of whether, and for what reasons, an *ex ante*-focused rule may be preferable to an *ex post*-oriented standard. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559-60 (1992) (articulating along these lines, the differences between rules and standards). There are notable cost/benefit tradeoffs with either. See *id.* at 562-63 (“Rules are more costly to promulgate than standards because rules involve advance determinations of the law’s content, whereas standards are more costly for legal advisors to predict or enforcement authorities to apply because they require later determinations of the law’s content.”). Although this article does not make a net social efficiency argument for better *ex ante* materiality guidance, the need for that guidance also may be supportable on that basis. *Id.*

125. Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 636 (2002).

126. See sources cited *supra* note 105 and accompanying text (noting that transaction planners may be incentivized to advise insiders not to trade at all); see also Lisa J. Finnell, *United States v. Carpenter: Second Circuit Overextends the Misappropriation Theory of Criminal Liability Under Rule 10b-5*, 12 DEL. J. CORP. L. 605, 612 n.34 (1987) (“market participants may act conservatively in trading on nonpublic information for fear that their conduct may inadvertently fall under the prohibitions against insider trading.”); Steven R. Salbu, *Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach*, 66 TUL. L. REV. 837, 856 (1992) (“[T]ransactions that may in fact be legal will be avoided by the risk averse because of the chilling effect that results from ambiguous standards . . .”). But see Fried, *supra* note 75, at 331 (reasoning that although “Rule 10b-5 prohibits trading on inside information only when the information meets the strict legal standard of materiality . . ., even in these cases, Rule 10b-5 cannot always deter insiders from trading on such information.”).

127. See generally Finnell, *supra* note 126 (discussing an advantage and disadvantage of ambiguity in insider trading law).

128. See *id.* (asserting that “market participants with access to inside information and who are planning to use such information to their advantage may consider that the ambiguity of the law reduces their likelihood of being caught”); see also Nnona,

other hidden or ignored costs associated with the statutory or regulatory ambiguity that more than offset the perceived benefits of the ambiguity.<sup>129</sup> These offsetting costs may neutralize any perceived positive relationship between the ambiguity and underlying statutory or regulatory policy and, in extreme cases, may cause the ambiguity to do violence to underlying policy.<sup>130</sup>

Accordingly, to assess the overall impact of ambiguity in the interpretation and application of the existing materiality standard in the context of insider trading, it is important first to understand the net effect of this ambiguity on the key policies underlying U.S. insider trading regulation. Parts III and IV principally are dedicated to this task.

### III. KEY LEGISLATIVE, REGULATORY, AND JUDICIAL POLICIES

#### A. *Policies Underlying the Application of Rule 10b-5 to Insider Trading Cases*

Existing ambiguities in the interpretation and application of the current materiality standard are not necessary to a fair and honest operation of U.S. securities trading markets, free from any breach of

---

*supra* note 78, at 221-23 (describing the difficulty faced by the SEC in defining and detecting violations of insider trading laws); Salbu, *supra* note 126, at 856-57 (indicating that “transactions that may be illegal will be entered into by those who are relatively risk prone under unclear guidelines . . .”); *see also* sources cited *infra* note 134.

129. *See* Nnona, *supra* note 78, at 223-25 (examining the costs associated with enforcing the insider trading prohibition); *see also* Salbu, *supra* note 126, at 856-57 (noting that another cost of the ambiguities in U.S. insider trading regulation is the deterrence of legal trading activity). Undue risk of criminal enforcement also may be a cost associated with ambiguities in current U.S. insider trading regulation. Professor Hicks notes:

[T]he United States considers insider trading a threat to fair and efficient securities markets . . . . At present, neither the federal statutes nor the Commission’s rules define this crucial term and U.S. Supreme Court decisions that have addressed the issue do not resolve ambiguities about either the scope or the underlying theory of this variety of fraud. The uncertain parameters of insider trading under U.S. law are more than an inconvenience. In addition to creating the risk of civil liability, a violation of statutory provisions or SEC rules that prohibit insider trading can result in a criminal conviction.

J. William Hicks, *Securities Regulation: Challenges in the Decades Ahead*, 68 IND. L.J. 791, 801-02 (1993).

130. *See* Nnona, *supra* note 78, at 224 (arguing that the inability of the SEC to keep up with all of its duties compromises the purpose of the 1933 Act and the 1934 Act); Salbu, *supra* note 126, at 858 (noting that ambiguities in U.S. insider trading regulation result in an overall reduction in the volume of market trading transactions and asserting that “[u]nnecessary impediments to the voluntary and lawful functioning of securities markets are inefficient and insupportable.”)

trust by issuers and their insiders.<sup>131</sup> It is a fundamental principle of U.S. insider trading regulation that issuers and their insiders not be permitted to benefit personally from any information advantage they may have over other traders in the secondary markets.<sup>132</sup> Better guidance on materiality, if well crafted, should not detract from adherence to this policy and principle.<sup>133</sup> Rather, such guidance should allow easier identification of the nature of information that, if possessed at the time of a purchase or sale of securities, creates an improper benefit and, as a result, should lead to more certainty and success in civil and criminal enforcement.<sup>134</sup>

---

131. See Panel Discussion: *The SEC's Regulation FD*, 6 FORDHAM J. CORP. & FIN. L. 273, 278 (2001) (comments of Harvey Goldschmid noting that the insider trading's capacity to undermine "investor confidence in the fairness and integrity of our markets" is a policy underlying insider trading regulation); Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 103 (1998) ("The SEC's insider trading policy is best understood as an effort to achieve fair pricing in the public securities markets in furtherance of the general goals of the statute."). A key element of this policy is the "investor confidence" rationale for federal insider trading regulation. See Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985) (asserting that investors must be confident that they can trade securities without being victims of informational disadvantages); see also Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1325-28 (1999) (acknowledging this policy rationale in current U.S. insider trading regulation, but contending that "the connection between insider trading regulation and the necessary baseline of investor confidence is at best speculative"); Nnona, *supra* note 78, at 208 (stating that "[t]he contention here is that insider trading harms the market by eroding public confidence" and that "[a]t its root, this contention is related to notions of fairness"); Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407 (2002) (discussing investor confidence in the context of investor behavior); see also sources cited *infra* note 149 (regarding the relationship among insider trading regulation, stockholder value, and investor confidence).

132. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961) (explaining that an important purpose of the 1934 Act was to eliminate the idea that corporate officials use inside information for personal gain); Helen A. Garten, *Insider Trading in the Corporate Interest*, 1987 WIS. L. REV. 573, 614-15 (1987) (commenting that "the evil of insider trading is the trader's misuse of business information for personal gain, which justifies taking away the trader's profits.").

133. See Salbu, *supra* note 126, at 855-59 (making this argument with respect to ambiguities in insider trading regulation generally).

134. One scholar notes:

Only the government has been reluctant to value lucidity and predictability; in its opposition to legislatively-defined insider trading, it valued enforcement flexibility above all else. Clarity and certainty have special force in criminal prosecutions, but also retain great importance in the civil area. If guided by these concepts, insider trading law would likely yield either new statutory or administrative definitions or, at the very least, bright-line liability criteria in case precedent.

Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1206 (1997); see Fried, *supra* note 75, at 310 ("Rule 10b-5 cannot easily deter insiders from trading on material inside information in the many cases where there is little likelihood that a violator will be detected and punished."); Salbu, *supra* note 126, at 857-58 (stating and



*B. Policies Underlying Section 10(b) and Rule 10b-5*

From a more general policy perspective, Section 10(b) and Rule 10b-5 were designed to protect investors and promote the integrity of our securities markets by preventing fraud, manipulation, and deception in connection with the purchase or sale of a security.<sup>135</sup> While the inherent ambiguities in the current legal standard governing materiality may allow courts more latitude to find, or otherwise fashion relief for, fraud, manipulation, or deception based on notions of equity not inconsistent with existing legal precedent (which power undoubtedly serves as a deterrent), these ambiguities are not necessary to the protection of investors and the promotion of integrity in our securities markets.

In fact, these ambiguities may negatively impact investor protection and market integrity because of their effect on the decisions of governmental bodies and private parties as to whether (and if so, how) to pursue conduct that the investing public believes should or does constitute illegal insider trading.<sup>136</sup> In an environment with limited resources, a prospective plaintiff, enforcement agency, or prosecutor logically would be more likely to invest those limited resources on a clear-cut case than a case that promises complex and difficult issues of proof.<sup>137</sup> If public and private enforcement of the

---

critiquing the argument that greater specificity leads to less enforcement). Difficulties encountered in enforcing current law in the area of insider trading and other corporate fraud have been noted in the press. *See, e.g.,* Andrew Countryman, *Window of Opportunity; Talk About Good Timing: Execs Sell Before the Fall*, CHI. TRIB., Mar. 2, 2003 (noting various enforcement difficulties with respect to purchases and sales of securities by insiders); France & Carney, *supra* note 9, at 35 (suggesting that the uncertainties (among other things) that prosecutors face in pursuing corporate fraud cases may limit the number of convictions).

135. *See* United States v. O'Hagan, 521 U.S. 642, 658-59 (1997) (examining the congressional purpose behind Section 10(b)); Santa Fe Indus. v. Green, 430 U.S. 462, 473 n.13 (1977) (noting the legislative history of Section 10(b) regarding intent to cover manipulation and deception); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-03 (1976) (citing to legislative history to show that Section 10(b) was enacted to prevent the use of "manipulative" and "deceptive" devices, indicating the implicit requirement of an element of scienter); Bryan S. Schultz, Casenote, *Feigning Fidelity to Section 10(b): Insider Trading Liability After United States v. O'Hagan*, 66 U. CIN. L. REV. 1411, 1416-18 (1998) (summarizing the legislative history behind Section 10(b) and Rule 10b-5); Seligman, *supra* note 131, at 1115 (examining the importance of the integrity of the market as a policy underpinning for Section 10(b)); Thel, *supra* note 17 (describing, in detail, the policy underpinnings of Section 10(b) in the context of the 1934 Act).

136. *See* David S. Escoffery, *A Winning Approach to Loss Causation Under Rule 10b-5 In Light of the Private Securities Litigation Reform Act of 1995*, 68 FORDHAM L. REV. 1781, 1792-93 (2000) (contending that ambiguity as to the elements of a Rule 10b-5 claim may have adverse consequences).

137. *See* Fried, *supra* note 75, at 333. This phenomenon may occur less frequently in a plaintiffs' bar-initiated class action in which the plaintiff's counsel may assess litigation risk based more on the probability, timing, and dollar value of a possible

securities laws is to be an effective method of preventing and punishing fraud, manipulation, and deception as a means of assuring investors of the integrity of our securities markets, then U.S. securities regulation should allow for more straightforward identification and punishment of violators.

A less ambiguous materiality definition can be fashioned that neither affords issuers and insiders a clear path around liability for fraudulent, manipulative, or deceptive conduct nor forces issuers and insiders to disclose minutia.<sup>138</sup> Clearer, more precise, materiality guidance would better support efficient and effective action against alleged insider traders by more clearly defining conduct that constitutes fraud, manipulation, or deceit, thereby enhancing investor protection and market integrity.<sup>139</sup>

### C. Policy Support for Disclosure Under the 1934 Act Generally

The 1934 Act and the rules and regulations thereunder, taken as a whole, are geared to the protection of investors and engenderment of public confidence in the integrity of the securities markets, primarily through the complete and accurate public disclosure of important issuer and transaction information.<sup>140</sup> The 1934 Act mandates both periodic and transaction-based public disclosures by issuers and others.<sup>141</sup> Moreover, in requiring the complete and

---

settlement than the probability, timing, and dollar value of a favorable judgment. *See infra* notes 198-200 and accompanying text.

138. That was a stated objective of the Court in *Basic*. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

139. Even in the class action area, a firm may be more willing to take on a case where the materiality of the nonpublic information at issue in the case is clear. *See generally* O'Hagan, *supra* note 134 (noting the enforcement issues arising from an ambiguous body of insider trading law).

140. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-78 (1977). One commentator notes:

Disclosure serves the underlying purposes of the securities laws. The market is protected against the prolonged effects of selective disclosure of material information. Disclosure provides a sorely needed disincentive against insider trading that is not dependent on SEC enforcement against identified individuals. Market integrity is promoted. Finally, disclosure insures that investors who have no special sources of information and are less adept at following market signals have important information before them in an understandable form. Any other rule would imply that investors who fail to watch the Dow Jones tape do so at their own peril.

Barragar, *supra* note 76, at 103 (footnote omitted).

141. *See, e.g.*, 15 U.S.C. § 78m(a) (2003) (providing for required disclosure by issuers in periodic reports); 15 U.S.C. § 78m(d) (2003) (providing for required disclosure by "persons acquiring more than five per centum of certain classes of securities"); 15 U.S.C. § 78n(c) (2003) (providing for required disclosure by issuers and others in proxy and information statements in connection with meetings of stockholders); 15 U.S.C. § 78n(d) (2003) (providing for required disclosure by issuers and others in connection with tender offers); 15 U.S.C. § 78p(a) (2003)

accurate disclosure of material facts in specific contexts, anti-fraud rules act as gap-filling disclosure rules.<sup>142</sup> The regulation of insider trading under Section 10(b) and Rule 10b-5 through the “disclose or abstain” rule is but one example of many.<sup>143</sup>

Yet, the ambiguities encountered by transaction planners in interpreting and applying the existing legal standard for materiality frequently discourage, rather than encourage, public disclosure of important issuer and transaction information.<sup>144</sup> An issuer or insider may forego securities trading (and the attendant public disclosure obligation) rather than trade and assume the risk of a lawsuit that second-guesses, *ex post*, the issuer’s or insider’s *ex ante* materiality analysis.<sup>145</sup> While this may be appropriate (and ultimately unavoidable) under certain circumstances, those circumstances should be limited. More specific materiality guidance can provide appropriate limits and should result in a higher quantity and quality

---

(providing for required disclosure of beneficial ownership of securities by directors, officers, and principal stockholders); *see also infra* note 209.

142. *See* Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 291-92 (discussing how mandatory disclosure sets “a minimum disclosure floor” and “ensures that silence is not always an option for issuers when evading the antifraud provisions”). *But see* Gregory S. Porter, *What Did You Know and When Did You Know It?: Public Company Disclosure and the Mythical Duties to Correct and Update*, 68 FORDHAM L. REV. 2199, 2255 (2000) (arguing against the use of antifraud rules in this manner).

143. *See e.g.*, 15 U.S.C. § 77k (2003) (governing misstatements and omissions in 1933 Act registration statements); 15 U.S.C. § 771(a) (2003) (governing misstatements and omissions in prospectuses and other communications under the 1933 Act); 15 U.S.C. § 77q(a) (2003) (governing fraud in the offer or sale of securities); 17 C.F.R. § 240.14a-9 (2003) (governing misstatements and omissions in proxy statements); 17 C.F.R. § 240.14e-3 (2003) (governing fraud in connection with tender offers).

144. *See* Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 355 (1988) (noting, with respect to insider trading law generally, that “[f]ew believe that a rule requiring the possessor of inside information to disclose or abstain from trading results in more disclosure than abstention.”); Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U. L. REV. 1473, 1517 (1986). In a recently released study, the Securities Industry Association (“SIA”) reports that Regulation FD (a two-year-old disclosure regulation that, like Rule 10b-5, uses materiality as a disclosure filter) has resulted in the public disclosure of less information by the public companies to which it applies than had been made before adoption of Regulation FD. *See Reg. FD Report, supra* note 83, at 12. Other studies and surveys also indicate that, to some degree, Regulation FD has had this effect. *See id.* The same SIA study finds that there also has been an adverse effect on the quality of publicly disclosed information. *See id.* at 12-13. There is also some corroboration of this finding in other surveys. *See id.* Accordingly, it may not be true that “the flexibility of the materiality standard provides an efficient balance between the investors’ informational needs and the benefits provided by allowing managers to trade.” O’Connor, *supra* note 75, at 363.

145. *See infra* Part IV.B.

of disclosure in circumstances in which disclosure is required to be made.<sup>146</sup>

#### IV. IMPACTS ON STOCKHOLDER VALUE

Neither policies underlying insider trading regulation, Section 10(b), Rule 10b-5, and the 1934 Act as a whole, nor the federal securities laws and regulations provide a guarantee of value preservation or value enhancement to investors.<sup>147</sup> Yet, the effects of law and regulation on stockholder value<sup>148</sup> do affect public perceptions about the effectiveness of investor protection and public

---

146. See Saul Levmore, *Licensing: Permission Slips in Corporate and Fourth Amendment Law*, 93 NW. U. L. REV. 709, 714 n.14 (1999) (noting in another context the argument that “disclosure would be more likely if courts would articulate the ‘real’ rule applicable”). The validity of this contention depends upon at least three things: (1) the ability of the rule maker (Congress, the SEC, or the courts) to clearly and comprehensively articulate more specific materiality guidance; (2) the benefits of disclosure under that enhanced guidance outweighing the detriments (such that issuers and insiders are encouraged to disclose, rather than abstain from trading); and (3) actual compliance by issuers and insiders with the enhanced guidance. Assessment of these factors is, to some extent, dependent on a more detailed analysis of the incentives provided by specific and generalized disclosure obligations. See Bernard S. Black, *Legal Theory: Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 546 n.9 (1990) (noting that “the debate over whether disclosure rules should be mandatory would benefit from analysis of when SEC disclosure rules simply mandate disclosure that companies would provide anyway, when they require more than private actors would provide, and when securities law liability discourages disclosure that would otherwise be made.”).

147. See *In re Penn Cent. Sec. Litig.*, 62 F.R.D. 181, 185 (E.D. Pa. 1974) (“[H]owever broadly the terms of § 10(b) and Rule 10b-5 may be construed, the Act and the Rule do not protect all who may have sustained a loss as a result of deceptive practices.”).

148. The concept of stockholder value is not widely recognized in the law and can mean different things to different people in different contexts. See Panel Discussion, *Reform: Are There Too Many Cooks in the Corporate Kitchen?*, 2 FORDHAM FIN. SEC. & TAX L. F. 67, 89 (1997) (including definitions of stockholder value in response to a question regarding the same from moderator Jill Fisch); see also Janis Sarra, *Convergence Versus Divergence, Global Corporate Governance at the Crossroads: Governance Norms, Capital Markets & OECD Principles for Corporate Governance*, 33 OTTAWA L. REV. 177, 210 (2001-02) (discussing the differing views of stockholder value in Europe and the United States); Symposium, *Corporate Citizenship: A Conversation Among the Law, Business and Academia*, 84 MARQ. L. REV. 723, 726, 747 (2001) (referencing the comments of Professor Lawrence E. Mitchell on stockholder value). For purposes of this article, stockholder value is defined simply as a net dollar-value enhancement in a stockholder’s equity holdings of an issuer, measured most easily (but not exclusively, or even accurately) by reference to the price of the issuer’s stock in the public securities markets. Increases should reflect the proportional sharing of net corporate benefits (dollar-value enhancements) and decreases represent the proportional sharing of net corporate detriments. In so defining stockholder value, this article does not argue the merits of a market value-driven method, or any particular method, for valuing the firm or measuring stockholder value. These matters are part of a broader scholarly debate beyond the scope of this Article. Michael R. Schwenk, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649, 658-62 (1994); Samuel C. Thompson, Jr., *A Lawyer’s Guide to Modern Valuation Techniques in Mergers and Acquisitions*, 21 J. CORP. L. 457 (1996).

confidence in the integrity of our securities markets. If insider trading regulation has negative impacts on perceived or actual stockholder value, investors are likely to feel either totally vulnerable or under-protected and lose confidence in the integrity of those markets.<sup>149</sup> Accordingly, it is important to identify perceived and actual negative impacts of the current materiality standard on stockholder value as additional support for the institution of enhanced substantive clarity in U.S. insider trading regulation, including by way of more specific materiality guidance.

#### A. *Insider Trading and Stockholder Value*

The overall effects of insider trading regulation on stockholder value have been debated for decades, with no absolute truth emerging.<sup>150</sup> Some scholars argue that unregulated insider trading enhances stockholder value.<sup>151</sup> These scholars generally articulate two bases for their arguments: (i) unregulated insider trading tends to increase the price efficiency of the market by more accurately

---

149. Although the relationship among insider trading regulation, stockholder value, and investor confidence is unclear, these themes permeate various debates regarding the desirability of insider trading and existing insider trading regulation. See generally Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 321 (2002) (describing and noting Henry Manne's work on the relationship between insider trading regulation and stockholder value); Franklin A. Gevurtz, *Transnational Business Law in the Twenty-First Century: The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L LAW. 63, 95-96 (2002) (contending that enforcement, rather than mere enactment, of insider trading prohibitions may promote "deep and liquid markets"); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1468 (1986) (positing that "the legal prohibition against insider trading prevents shareholders from reaching compensation agreements with the managers of their firms that would make both sides better off."); Spencer Derek Klein, Note: *Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665, 673 (1988) (noting that "investor confidence is not simply a function of the ability to enforce the securities laws' prohibition of insider trading" and that "the factors that impact upon investor confidence are numerous and interrelated."); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1325-26 (1999) (describing perceived relationships between insider trading regulation and stockholder value); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 10 n.2 (1984) (noting that insider trading itself may undermine investor confidence); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 383 n.26 (1999) ("the economic arguments in favor of insider trading law that rely on arguments about promoting investor confidence depend in part on an assumption that investors are more likely to invest funds in markets that are felt generally to be ethical or fair.").

150. See generally HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Richard W. Painter, *Insider Trading and the Stock Market Thirty Years Later*, 50 CASE W. RES. L. REV. 305 (1999) (describing Henry Manne's work and legacy in the economic analysis of insider trading).

151. See Painter, *supra* note 150 and sources cited *infra* notes 152 & 153.

reflecting all available information in the market price of securities<sup>152</sup> and (ii) unregulated insider trading efficiently compensates corporate insiders for managing the firm in a manner that leads to a higher firm value.<sup>153</sup> Others argue that some form of insider trading regulation is needed, at least for some issuers and their insiders, to maximize stockholder value. These scholars state varying points of view. Some acknowledge the value-enhancing attributes of insider trading, but document costs that exceed these benefits while others quarrel with the contention that all unregulated insider trading is value-enhancing.<sup>154</sup>

This Part does not propose to enter into the general debate about the effects of insider trading regulation on stockholder value. Rather, it assumes that insider trading regulation is here to stay and, instead, focuses on ways in which existing U.S. insider trading regulation—with its unclear, imprecise materiality standard—detracts from stockholder value. Specifically, this Part supports the proposition that the lack of clarity and precision in that materiality standard creates additional transaction costs that are not apparently offset by any resulting benefit.

#### B. *Foregone or Delayed Transactions*

One impact on stockholder value is created by the issuer or an insider determining to not engage in, or to delay the commencement of, a value-enhancing transaction<sup>155</sup> because of dual determinations

---

152. See Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866-72 (1983). But see Fried, *supra* note 75, at 315-16 (critiquing this claim).

153. See James Harlan Koenig, Comment, *The Basics of Disclosure: The Market for Information in the Market for Corporate Control*, 43 U. MIAMI L. REV. 1021, 1033 (1989) (“[S]everal commentators assert that, if corporate managers were partially compensated by being allowed to utilize the value of the nonpublic information that they discover through their positions, the corporation and its shareholders would benefit due to the generation of certain managerial incentives.”); Manne, *supra* note 150, at 30-31; Carlton & Fischel, *supra* note 152; Henry G. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY 21 (1974); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 554-55 (1970).

154. See Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 110-12 (1998); see also Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227, 270-71 (1998).

155. Value-enhancing transactions by issuers are relatively easy to conceptualize in this context. See Koenig, *supra* note 153, at 1046, 1076 (noting, with respect to materiality in the insider trading context, that “[s]tandards that are not in the form of a bright-line rule, like the probability/magnitude test, fail to provide managers with the flexibility and freedom necessary to maximize shareholder value by entering the arena for corporate control”). The stockholder value-enhancing nature of an insider’s trading transaction may be harder to fathom. However, arguments can be

that (1) the issuer or insider is, or may be, in possession of material information not yet disclosed to the public and (2) the material nonpublic information in the actual or possible possession of the issuer or insider cannot, or (for strategic or other reasons) should not, be disclosed.<sup>156</sup> Under these circumstances, the “disclose or abstain” rule effectively means “abstain,” and the issuer or insider must forgo the desired trading transaction until such time as the information is either immaterial or publicly disclosed and disseminated.<sup>157</sup> This is true regardless of the potential public or personal benefits associated with the desired transaction.<sup>158</sup> The issuer or insider cannot, then, engage in a trading transaction while in possession of possibly—but not clearly—material information, even if the transaction would tend to increase short-term or long-term stockholder value.<sup>159</sup> Examples of issuer trading transactions that might need to be foregone or delayed under these circumstances

---

made that the purchase of an issuer’s securities by a director or officer is value-enhancing. The principle argument in this regard is that the director’s or officer’s ownership of the issuer’s securities brings his or her economic interests in line with those of other issuer stockholders, thereby incentivizing the director or officer to maintain or create market value in the issuer’s shares for the benefit of all stockholders. See Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 134 (1996); Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 8-10 (2000). The public sale of issuer stock by a director or officer also may be seen as value-enhancing in that the emotional goodwill engendered by the additional compensation represented by any financial gain realized in that sale, while not paid to the insider by the issuer, may incentivize the director or officer to higher levels of performance on behalf of stockholders on an ongoing basis, especially if combined with additional, unrealized equity incentives. See David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 444 (2000) (arguing that “new unvested grants are supposed to preserve the desired incentive”) (footnote omitted). Alternatively, however, giving an executive complete freedom to time his or her sale transaction may result in the executive profiting from the sale at the expense of the issuer’s other stockholders. See Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 759, 829-31 (2002).

156. See *Basic Inc. v. Levinson*, 485 U.S. 224, 234-35 (1988) (discussing the possible importance of secrecy in merger negotiations). One can imagine any number of situations other than pre-merger discussions and negotiations in which an issuer or insider may need or desire to remain silent. These instances might include, for example, the existence of contractual confidentiality restrictions or possible involvement as a plaintiff or defendant in significant threatened litigation.

157. See Bacastow, *supra* note 74, at 131-32 (noting that, in the context of insider trading, “Rule 10b-5’s inherent inability to provide adequate notice leads to the deterrence of legitimate trading activities”); O’Connor, *supra* note 75, at 366 (noting the potential for deterrence of “legitimate activity”); Salbu, *supra* note 126, at 856 (“under unclear guidelines . . . transactions that may in fact be legal will be avoided by the risk averse because of the chilling effect that results from ambiguous standards”).

158. See Salbu, *supra* note 126.

159. See *supra* notes 155 & 157 (discussing value enhancing transactions and the potential inhibitions that Rule 10b-5 places on trading activity).

include open market stock repurchase programs, self-tender offers to retire all or part of an outstanding class or series of economically disadvantageous securities, and private and public offerings at favorable prices.<sup>160</sup>

Suppose, for example, that an issuer has announced a market repurchase program with certain established price and timing requirements.<sup>161</sup> Market repurchase programs generally enhance stockholder value because they provide for the distribution of corporate funds to stockholders, reduce the number of outstanding shares of the issuer (enhancing per-share valuations for ongoing stockholders), and typically cause the market price of the issuer's stock to rise (absent offsetting transactions, events, or public disclosures), at least for the short term.<sup>162</sup> Moreover, market repurchases may be a more efficient way to increase stockholder value than, for example, the declaration and payment of dividends, which would not implicate the insider trading "disclose or abstain" rule, since no purchase or sale of securities is involved.<sup>163</sup>

Market repurchase programs consist of purchases by an issuer of its own securities in the open market.<sup>164</sup> Accordingly, under the "disclose or abstain" rule, an issuer that desires to institute, or continue operating in, a market repurchase program must ensure that it is not in possession of material nonpublic information before engaging in purchases under the program.<sup>165</sup> Where (i) a corporate

---

160. Each of these transactions represents a purchase (open market stock repurchase program or self-tender offer) or sale (private or public offering) of a security by the issuer that is subject to the "disclose or abstain" rule, in addition to any mandatory disclosure obligations prescribed by federal securities law or regulation.

161. See generally F. H. Buckley, *When the Medium is the Message: Corporate Buybacks as Signals*, 65 IND. L.J. 493, 493-96 (1990) (describing the nature and form of stock repurchase transactions).

162. See *id.* at 496 (describing different explanations for stock price increases associated with stock repurchases). See generally Ok-Rial Song, *Hidden Social Costs of Open Market Share Repurchases*, 27 J. CORP. L. 425 (2002) (describing stockholder value effects and other attributes of share repurchases).

163. See Laurie Simon Bagwell & John B. Shoven, *Cash Distributions to Shareholders*, 3 J. ECON. PERSP. 129, 129-30 (1989); Song, *supra* note 162, at 498-99; see also Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165, 1181 (2001).

164. See Enriques, *supra* note 163, at 1179 (discussing the market repurchase process); Jesse M. Fried, *Open Market Repurchases: Signaling or Managerial Opportunism?*, 2 THEORETICAL INQ. L. 865, 865 (2001) (describing an open market repurchase as a transaction "in which a corporation buys back stock in the open market, usually through a broker, over a period ranging from several months to several years.").

165. See Victor Brudney, *Equal Treatment of Share holders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072, 1108 (1983) ("Federal securities laws contemplate repurchases but require that the corporation adequately disclose the relevant considerations to the sellers."); Nagy, *supra* note 10, at 1178-79 (noting and



issuer possesses nonpublic information, (ii) a materiality determination cannot conclusively be made, and (iii) disclosure of the nonpublic information is not an available option,<sup>166</sup> the issuer typically will not institute (or will suspend operation of) a market repurchase program, despite its potential to increase stockholder value. For instance, if Example #2 were related to the application of the “disclose or abstain” rule in the context of an issuer stock repurchase transaction (rather than director stock purchases), the three enumerated facts in the preceding sentence may be deemed to be present, and the issuer would suspend its market repurchases. Clearer materiality guidelines would enable an issuer in these circumstances to better ensure that the determination to forego or suspend a market repurchase program is made out of legal necessity, rather than legal uncertainty.

*C. Materiality Assessment and Decision-Making as a Management  
Distraction*

Stockholder value is negatively impacted by management’s inability to focus on the business and operations of the issuer.<sup>167</sup> A director or officer can focus on the business and operations of the issuer when distractions are minimized (or, ideally, eliminated). Management distractions may include time spent engaged in corporate or personal decision-making relating to a possible transaction in the issuer’s securities by the issuer or one of its officers or directors. Especially (but not exclusively) if the issuer has a securities trading policy<sup>168</sup> in

---

citing to cases in which the disclose or abstain rule has been applied to issuer stock repurchases).

<sup>166.</sup> See *supra* note 156 and accompanying text (positing situations in which an issuer may determine not to disclose information).

<sup>167.</sup> See Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 356 (1991) (mentioning management distractions in the context of shareholder initiatives as a cost).

<sup>168.</sup> The term “securities trading policy” is used in this article to refer to any corporate compliance program that relates to securities trading matters. These programs have their roots in the substance of U.S. insider trading regulation, especially the control person liability provision, 15 U.S.C. § 78t(a) (2003), and the Insider Trading and Securities Fraud Enforcement Act, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in various sections of Chapter 2B of 15 U.S.C. (2003)), as well as in New York Stock Exchange guidance and the federal sentencing guidelines. See generally Steven Chasin, Comment: *Insider v. Issuer: Resolving and Preventing Insider Trading Compliance Policy Disputes*, 50 UCLA L. REV. 859, 861-64, 869-74 (2003) (describing insider trading compliance policies and the bases for issuer liability for an insider’s trading transactions); Kevin B. Huff, Note, *The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach*, 96 COLUM. L. REV. 1252, 1267-72 (1996) (exploring certain rationales for compliance programs); Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. REV. 1783 (1994) (examining insider trading compliance programs).

place, the personal decision-making of an officer or director is directly intertwined with the operations of the issuer, making it more likely that the decision-making process will be a management distraction.<sup>169</sup>

In addition, regardless of the existence of a formal securities trading policy, an issuer may (and should) choose to institute securities trading blackout periods—periods of time during which neither the issuer nor its insiders are permitted to trade in the issuer's securities because of the deemed or actual possession by the issuer and its insiders of material nonpublic information—at appropriate times.<sup>170</sup> Before issuing a “no-trading” directive to commence such a blackout period, the issuer's management typically participates in determining the materiality of any nonpublic information in the possession of the issuer and its insiders.<sup>171</sup> During the blackout period, management assesses and responds to requests from insiders who have an emergent need or desire to trade. Management determines when the blackout period ends.

Even in the absence of a formal securities trading policy or corporate directive that expressly prohibits or restricts trading by the issuer or insider in an issuer's securities, the proposed securities trader (whether it be the issuer or one of its directors or officers)

---

169. Many securities trading policies rely in part on the use of trading windows, periods of time during which insiders are permitted to trade in the issuer's securities (absent the possession of material nonpublic information). See Fried, *supra* note 75, at 345-49. There are many other different types and forms of securities trading policy. See Steinberg & Fletcher, *supra* note 168, at 1829-36. See generally Alan Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180 (1990).

170. See Bebchuk et al., *supra* note 155, at 830 (referencing the use of trading windows and blackout periods as a means of preventing executive stock trading); Chasin, *supra* note 168, at 863 (explaining the nature of a blackout period); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and “Negative” Property Rights in Information*, 87 VA. L. REV. 1229, 1261 n.106 (2001).

171. See Chasin, *supra* note 168, at 868-69 (noting that “[m]ateriality presents a . . . problematic determination for compliance officers” in the insider trading context). Management makes similarly problematic materiality determinations in other securities regulation contexts. See Pritchard, *supra* note 70, at 936 (noting that corporate management and counsel make materiality determinations required by disclosure regulation); Scott Russell, Note, *Regulation Fair Disclosure: The Death of the Efficient Capital Market Hypothesis and the Birth of Herd Behavior*, 82 B.U.L. REV. 527, 539 (2002) (noting that under Regulation FD, “corporate managers must make materiality determinations on-the-spot, without any guidance from the SEC regarding what information would be considered material.”); Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 959, 983 n.93 (1996) (noting that management determines the materiality of a lawsuit to an issuer in assessing whether to disclose it in an annual report); R. Gregory Roussel, *Securities Fraud or Mere Puffery: Refinement of the Corporate Puffery Defense*, 51 VAND. L. REV. 1049, 1091 (1998) (noting that materiality determinations typically come from corporate officers or other representatives).

should, and logically would, assess the materiality of any nonpublic information before engaging in securities trading. This assessment is a key element in the decision-making about whether the issuer or its insiders will, in fact, trade in the issuer's securities. The complexity and, in many cases, inconclusive results of the analyses that underlie this assessment, whether or not prompted by a formal securities trading policy or a corporate desire to identify and communicate the existence of securities trading blackout periods, creates significant distractions for any director or officer participating in the corporate or personal decision-making and for in-house counsel participating in that process (as applicable).<sup>172</sup> The analytical complexity of materiality determinations and the inconclusive nature of the results obtained are ordained in principal part by the ambiguity of the existing materiality standard. While no empirical research located to date directly demonstrates the magnitude of the costs associated with the management distractions created by this complexity and inconclusiveness, the distractions logically must detract from stockholder value.

Having said this, however, these distractions should not be of concern if the stockholder value benefits of the materiality assessment process equal or exceed the costs associated with that process. Under those circumstances (i.e., where stockholder value benefits equal or exceed costs), the materiality assessment process cannot be said to have a net negative effect on stockholder value. For example, if the materiality assessment process were to effectively insulate the issuer and its insiders from prolonged involvement in an expensive legal action based on that materiality assessment, we might find that the stockholder value benefits of engaging in the assessment

---

172. In the case of a desired trade by a director or officer of the issuer, while the formalized decision-making process may not be directly connected with the issuer, a director or officer still would be likely to involve the issuer's counsel and to handle transactional questions and decision-making during business hours; potentially decreasing the amount or effectiveness of time spent by all on the issuer's business.

See Terry Fleming, *Perspectives on Business Law: Telling the Truth Slant—Defending Insider Trading Claims Against Legal and Financial Professionals*, 28 WM. MITCHELL L. REV. 1421, 1438 (2002) (“An insider who consults with and relies on the advice of legal counsel prior to engaging in a trade may use those circumstances to demonstrate good faith and the lack of scienter.”); Patrick D. Harvill, Note: *The Forgotten Warrior: Section 12(2) of the Securities Act of 1933 and the Battle Against Insider Trading*, 90 COLUM. L. REV. 226, 238 (noting the Supreme Court's view, expressed in *Bateman Eichler, Hill Richards, Inc. v. Berner et al.*, 472 U.S. 299, 317 (1985), that “insiders . . . are relatively sophisticated and have access to legal counsel”); Henry L. “Scott” Nearing, III, Note: *Kahn v. Virginia Retirement System: The Impact of Rule 10b-5's Corporate Disclosure Requirements on the Williams Act's Tender Offer and Best Price Rules*, 40 VILL. L. REV. 263, 299 (1995) (suggesting that “corporate management . . . develop procedures assuring that corporate personnel, familiar with the current state of public information, pre-approve all insider trades.”).

process exceed the costs of engaging in that process. Where the issuer or an insider decides to trade in the issuer's securities after making such an assessment, however, the vagueness of the existing materiality standard and the uncertain results frequently obtained by its application to specific facts may tend to encourage, rather than discourage, the commencement of litigation (including expensive, time-consuming, settlement-focused securities fraud class action litigation) against the issuer or insider or both.<sup>173</sup> Better materiality guidance logically should enable issuers and their insiders to make decisions borne out of an increased level of certainty, decreasing the risk that litigation is brought or sustained.<sup>174</sup>

#### D. *The Cost of Outside Counsel*

Frequently, outside counsel is involved in the materiality assessment process when the issuer or one of its insiders desires to trade in the issuer's securities.<sup>175</sup> This involvement may occur regardless of firm or legal department size and may be most related to the perceived visibility, importance, or degree of difficulty of the materiality determination.<sup>176</sup> Corporate transactional counsel tend to face materiality determinations like those emanating from the facts of Example #2 (which, as you may recall, invokes the possible materiality of premerger negotiations) on a regular basis. The costs of retaining outside counsel may be relatively high.<sup>177</sup> For issuers that both

---

173. The subject of securities fraud class action litigation is discussed in greater detail *infra* Part V.

174. Moreover, civil or criminal enforcement of insider trading prohibitions under Rule 10b-5 may be more likely where the materiality of any nonpublic information is apparent.

175. See Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOKLYN L. REV. 763, 850 n.232 (1995) (regarding outside counsel's potential role in making materiality determinations); see also Jerry Duggan, Note, *Regulation FD: SEC Tells Corporate Insiders to "Chill Out"*, 7 WASH. U. J.L. & POL'Y 159, 182 (2001) (noting that law firms stand to benefit from the need for interpretation of ambiguous language in Regulation FD). One securities regulation casebook notes that: "[b]ecause the materiality concept is such a workhorse in securities regulation, learning to apply it is probably the most valuable skill a securities lawyer can acquire." Cox et al., *supra* note 51, at 40. A recent survey of lawyers conducted by an ABA task force confirms that legal advice is sought on the question of materiality in the context of Regulation FD. *Reg. FD Report, supra* note 83, at 13.

176. *Reg. FD Report, supra* note 83, at 13; Harold A. Segall, *Then and Now: The Commercial Practice of Law for Over Fifty Years*, 24 FORDHAM URB. L.J. 567, 570-71 (1997) (noting that outside counsel often is retained for important or specialized matters).

177. Comparisons of the cost of in-house representation and representation by outside counsel in litigation most often indicate that in-house representation is less expensive. See Charles Silver, *Flat Fees and Staff Attorneys: Unnecessary Casualties in the Continuing Battle Over the Law Governing Insurance Defense Lawyers*, 4 CONN. INS. L.J. 205, 241 n.118 (1997). But see Segall, *supra* note 176, at 569 (indicating that it may cost less to retain outside counsel).

employ in-house counsel and retain outside counsel for specialized work on corporate transactions, materiality assessments and determinations generally are made based on consultation between in-house and outside counsel, resulting in some duplication of effort (and, therefore, cost).<sup>178</sup>

The ultimate stockholder value analysis concerning the use of outside counsel is the same as that described above with respect to management distractions: the ambiguity inherent in the existing materiality standard results in the issuer incurring costs that are not offset by related benefits.<sup>179</sup> In principle, issuer costs associated with the retention of outside counsel in the materiality assessment process are somewhat easier to quantify than the costs associated with management distractions. Moreover, these costs consist of professional fees (typically determined by hourly billing at predetermined rates) and disbursements (including, e.g., online legal research, telephone, facsimile, and courier costs).<sup>180</sup> Hourly billing rates for partners and associates in different markets periodically are published in trade (and sometimes carried in general) news media.<sup>181</sup> There are many missing links, however, in precisely quantifying the costs associated with outside counsel participation in materiality assessments regarding insider trading transactions. These include (1) the number of assessments that are made, (2) the seniority of the attorney(s) engaged in the process, (3) the number of billable hours spent by each in that process, and (4) the dollar amount of any disbursements associated with each assessment. These cost factors vary and frequently are hidden in or indistinguishable from those associated with overall considerations made in connection with the structuring and implementation of a proposed transaction. However, the complex, unguided, fact-based,

---

178. Of course, the active involvement of in-house counsel in any matter handled by outside counsel may result in cost management benefits. See Segall, *supra* note 176, at 569 (discussing cost issues as part of the reasoning behind employing in-house or outside counsel). Moreover, expert outside counsel may be able to provide more efficient and cost-effective research on issues of materiality. These and other factors may result in certain efficiencies, but do not negate the fact that the use of outside counsel may generate costs beyond those generated by management distractions. *Id.*

179. See discussion *supra* Part IV.C (describing the potential effects of managerial distraction).

180. See generally Symposium, *What We Know and Do Not Know About the Impact of Civil Justice on the American Economy and Policy: Lawyer Fees and Lawyer Behavior in Litigation: What Does the Empirical Literature Really Say?*, 80 TEX. L. REV. 1943 (2003) (discussing various types of fee arrangements associated with legal practice).

181. See, e.g., *A Firm-by-Firm Sampling of Billing Rates Nationwide*, NAT'L L.J., Dec. 9, 2002, at B12; Ruth Singleton, *Firms Raised Hourly Rates in 2002*, LEGAL TIMES, Jan. 20, 2003, at 19.

individualized nature of materiality assessments under the current legal standard makes it likely that outside counsel at both senior and junior levels will spend many billable hours at the task. In addition to research and consultation, outside counsel may generate fees by preparing for and attending meetings of the issuer's board of directors to advise the issuer on materiality issues, especially where the issuer's trading is under inquiry. In exceedingly rare cases, outside counsel may be asked to render to the issuer a written legal opinion on a materiality question.<sup>182</sup>

Regardless of the precise, actual costs involved in outside counsel's participation in the materiality assessment process, however, there exist clear costs associated with the engagement of outside counsel as participants in the materiality assessment process.<sup>183</sup> These costs are not apparently offset by any actual or perceived stockholder value benefits associated with that engagement (apart from a potential intangible, institutional satisfaction that materiality determinations are being made by the most qualified decision makers). Again, there is no evidence, for example, that the involvement of outside counsel in materiality determinations: (i) better insulates the issuer or its insiders from legal action, including expensive, drawn out securities fraud class action litigation; (ii) leads to lower settlement value in any securities fraud litigation; or (iii) better ensures victory in such litigation after completion of an exhaustive, time-consuming, and costly trial and appeal process. In certain circumstances, the best that outside counsel can do, as earlier indicated, is to advise the issuer to forego or delay commencement of the transaction that causes the duty to disclose.

---

182. Outside counsel typically would resist rendering such an opinion except in the most obvious case (where the client typically would not request an opinion from outside counsel). Even in an obvious case, however, counsel likely would have to issue a reasoned or qualified opinion (e.g., "Based upon and subject to the foregoing assumptions, limitations, qualifications, and exceptions, while the matter is not entirely free from doubt, we are of the opinion that a court with proper jurisdiction should find the facts . . . material"). See Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 643 n.250 (1998) ("Opinions laden with foundational assumptions are known as 'reasoned opinions.'"). Any opinion rendered in a non-obvious case undoubtedly would be a highly qualified opinion with many carefully drawn, expressly stated assumptions, limitations, and exceptions.

183. This is a typically noted effect of the use of *ex post* legal standards. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 569 (1992).

## V. STOCKHOLDER VALUE IN THE CURRENT CLASS ACTION LITIGATION ENVIRONMENT

The current securities fraud class action environment creates, among other things, additional pressure on stockholder value, especially in the insider trading context. The lack of clarity around materiality contributes to this effect. Specifically, the current ill-defined legal standard governing materiality determinations makes pretrial dismissal of an insider trading class action difficult, regardless of the overall merits of the action.<sup>184</sup> For similar reasons, a trial defense based on immateriality is risky at best. These factors likely contribute to the large number and percentage of settlements in insider trading actions. These settlements decrease corporate resources available to stockholders (as residual claimants on the issuer's assets), without resulting in a proportional sharing among stockholders of the settlement payment or other benefits.<sup>185</sup>

This Part begins by briefly placing the current securities fraud class action environment into its historical context. Additionally, it provides some basic information about insider trading class actions. Finally, this Part describes and discusses the resulting need for substantive class action reform to address the materiality issue.

---

184. See Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71, 100 ("Under the definition of materiality adopted, it is difficult for a defendant to negate the element as a matter of law on a motion for summary judgment."); Fleming, *supra* note 172, at 1430 ("Motions for judgment on the pleadings and summary judgment are rarely granted, and the decision on materiality is ordinarily reserved for the fact-finder."). Courts have noted that summary judgment on the issue of materiality is not favored. See *TSC Indus.*, 426 U.S. at 450 (quoting *Johns Hopkins U. v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970)); *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561, 565 (9th Cir. 1985); ("Summary judgment is normally inappropriate for determining the materiality of undisclosed information."). Yet, a number of cases involving issues of materiality are decided on motions to dismiss or for summary judgment. See Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb In Securities Fraud Opinions*, 51 EMORY L.J. 83, 116 n.94 (2002) (noting, with respect to a group of review of securities fraud opinions, that "[o]f the 91 (out of 100) cases that were decided at the motion to dismiss stage, 64 involved materiality determinations in favor of the defendants (i.e., over 70 percent)").

185. For one thing, plaintiffs' bar attorneys in these class actions generally get paid out of any settlement funds. See Bruce L. Hay, *Asymmetric Rewards: Why Class Actions (May) Settle for Too Little*, 48 HASTINGS L.J. 479, 482 (1997); Denise N. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 121, 128-31 (1999) (describing class action fee arrangements generally). For another, depending on the facts (including whether the alleged injury occurred in connection with a purchase or sale when the action is brought, and whether stockholder plaintiffs opt out of participation in the action) the issuer's then existing stockholders may or may not be injured parties or plaintiffs in the action. See *infra* notes 203 & 204 and accompanying text.

A. *Historical Context of the Current Securities Fraud Class Action Environment*

The 1934 Act does not expressly provide for private rights of action for violations of Section 10(b) or Rule 10b-5. Such a right, however, long ago was held to be available.<sup>186</sup> Since that time, private actions—and, in particular, class actions—have become a popular way of enforcing securities fraud claims, including insider trading allegations.<sup>187</sup> By the mid-1990s, concerns about the number and propriety of securities fraud class actions had been loudly voiced.<sup>188</sup>

Accordingly, in 1995, Congress enacted the Private Securities Litigation Reform Act of 1995<sup>189</sup> (“PSLRA”) as a means of, among other things, reducing the number of (assertedly) specious securities class actions brought against issuers and reducing the primary role of plaintiffs’ bar counsel in initiating those class actions.<sup>190</sup> Data suggest that the PLSRA may have been largely ineffective at achieving these objectives.<sup>191</sup> More class action securities litigation was commenced in

---

186. See *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

187. The manner in which modern class action litigation developed made its application to insider trading actions inevitable. See Susan T. Spence, *Looking Back . . . in a Collective Way*, BUS. L. TODAY, July/Aug. 2002, at 21 (outlining the history of class action law).

188. See *id.* at 24; see also Wager & Ward, *supra* note 39, at 13; Charles H. Gray, Note, *An Economic Analysis of the Private Securities Litigation Reform Act: Auctions as an Efficient Alternative to Judicial Intervention*, 44 WM. & MARY L. REV. 829, 830-31, 833 (2002).

189. Pub. L. No. 104-67, 109 Stat. 737 (codified in various sections of 15 U.S.C. from §§ 77z-1 to 78u-5 (2000)).

190. See, e.g., *Securities Litigation Act, Hearing on S.1260 Before the Subcomm. on Sec. of the S. Comm. on Banking, House & Urban Affairs*, 105th Cong. 4-5 (1998) (testimony of John F. Olson, Gibson, Dunn, and Crutcher) (“The PSLRA was intended to stem the tide of frivolous nationwide class action lawsuits.”); Eugene P. Caiola, Comment, *Retroactive Legislative History: Scierter Under the Uniform Security Litigation Standards Act of 1998*, 64 ALB. L. REV. 309, 316 (2000); Roslyn Falk, *May a Shareholder Who Objects to a Proposed Settlement of a Derivative Action Appeal an Adverse Decision? A Report on California Public Employees’ Retirement System v. Felzen*, 25 DEL. J. CORP. L. 235, 243 (2000).

191. See Buckberg et al., *supra* note 39, at 12 (“[T]he 41% higher likelihood that any publicly-traded company will face a suit going beyond a motion to dismiss suggests that the plaintiffs’ bar is pursuing fraud more aggressively since PSLRA, rather than being limited by it.”); Stanford Law School Securities Class Action Clearinghouse, *supra* note 27. A case can be made that the PSLRA has been somewhat effective in that the post-PSLRA average rate of non-voluntary dismissals has increased, with a corresponding decrease in settlements. See Painter et al., *supra* note 39, at 7. But see Buckberg et al., *supra* note 39, at 5 (“Dismissal rates are statistically unchanged since PSLRA, despite the new, more specific standard of pleading that it set, with 12-13% of cases dismissed within three years both before and after, and few dismissals in subsequent years.”). The average dollar amount of each settlement is up. See Buckberg et al., *supra* note 39, at 7 (noting that average settlements more than tripled from 1996 to the first half of 2003); Painter et al., *supra* note 39, at 9-12. This dollar-value increase appears to be attributable to a few extremely large (i.e., high dollar-value) settlements in individual cases. *Id.*



2002 than in any other year for which data have been collected.<sup>192</sup> Based on data collected and analyzed by Stanford University and Cornerstone Research, the number of securities class actions brought in 2002 (other than initial public offering allocation cases) was 224, up from 171 in 2001. Since 1995, the trend in securities class actions has been stable to upward.<sup>193</sup>

The mere commencement of securities fraud class action litigation may have a measurable negative impact on the market value of the stock of a corporate issuer.<sup>194</sup> Damages claims and settlement amounts can be significant, and litigation costs are known to be high.<sup>195</sup> With a decreased market value, the corporate defendant may

---

192. See Cornerstone Research, *Securities Class Action Case Filings: 2002: A Year in Review*, available at Stanford Law School Securities Class Action Clearinghouse, *supra* note 27, at 2; see also Buckberg et al., *supra* note 39, at 2 (noting the same trend based on an analysis of different data).

193. See Buckberg et al., *supra* note 39, at 2; Stanford Law School Securities Class Action Clearinghouse, *supra* note 27. This data also may indicate that the PSLRA has failed to achieve its goals. Alternatively, the data may indicate the existence or discovery of more securities fraud, rather than continued or growing speculative, settlement-oriented litigation. It may be too early to tell which explanation carries the greatest weight with respect to recent actions, since cases brought in any given year settle out or otherwise devolve over a period of years. See Buckberg et al., *supra* note 39, at 5 (noting that there “has been a slowing of time to disposition due to later settlements” since adoption of the PSLRA). A recent paper suggests that market conditions explain best “the amount of securities litigation in federal courts and the type of allegations made in plaintiffs’ complaints.” Painter et al., *supra* note 39, at 6.

194. This seems intuitive. *But see* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 65-66 (1991).

195. See Nicole M. Briski, Comment, *Pleading Scienter Under the Private Securities Litigation Reform Act of 1995: Did Congress Eliminate Recklessness, Motive, and Opportunity?*, 32 LOY. U. CHI. L.J. 155, 156 (2000) (“Once a securities fraud lawsuit survives a motion to dismiss, the prohibitive cost of discovery provides an incentive for a corporation to settle the lawsuit, regardless of the company’s culpability.”); Franco, *supra* note 142, at 336 n.231 (2002) (referencing arguments that securities class action litigation overcompensates investors); Marilyn F. Johnson et al., In re Silicon Graphics Inc.: *Shareholder Wealth Effects Resulting From the Interpretation of the Private Securities Litigation Reform Act’s Pleading Standard*, 73 S. CAL. L. REV. 773, 782-83 (2000) (describing the costs to defendants in securities class action litigation); Jeffrey L. Oldham, Comment, *Taking “Efficient Markets” Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995, 1039 (2003) (referencing “the enormous litigation costs involved in securities fraud class actions” and their relationship to settlements); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 83 (“The Reform Act recognizes that suboptimal liability standards and procedural rules in securities class actions impose costs on issuers (good and bad) that are passed on to investors.”); Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 586-93 (2000) (discussing the relationships among damages claims, settlements, and class action litigation costs); see also Janine C. Guido, Note, *Seeking Enlightenment From Above: Circuit Courts Split on the Interpretation of the Reform Act’s Heightened Pleading Requirement*, 66 BROOK. L. REV. 501, 506 (2000). One published study documents average and median settlement values at \$23.3 and \$6.3 Million in 2002 and \$14.1 and \$5.1 Million in 2001, respectively. See Cornerstone Research, *Post-Reform Act Securities Case Settlements: 2001: A Year in Review*, available at Stanford Law School Securities Class Action Clearinghouse, *supra* note 27, at 2.

find it more difficult to conduct or finance its operations. Customer and supplier relationships may be damaged.<sup>196</sup> Debt and equity financing in public and private markets may be unavailable or less available; and institutional lenders may be unwilling or less willing to loan the issuer operating funds on a cost-effective basis.<sup>197</sup> Accordingly, the availability and value of both short-term and long-term investments in the issuer may be reduced by the mere commencement of a class action lawsuit.

Many securities class actions are settled before trial, and even before adjudication of a motion to dismiss.<sup>198</sup> A number of factors make settlement of these legal claims attractive to defendants.<sup>199</sup> Moreover, settlements are judicially encouraged—the earlier, the better.<sup>200</sup> Yet, payments made by an issuer in settlement of a class action lawsuit also represent a drain on stockholder value.<sup>201</sup> In these

---

196. See Johnson et al., *supra* note 195, at 783 (“[T]he mere existence of the class action may disrupt relationships with suppliers and customers, who may be somewhat leery of dealing with a party accused of fraud.”).

197. Accord Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 581 (1991) (“From the perspective of the capital markets, the economic costs of a non-merits-based system of resolving securities class actions should cause increases in the cost of capital in the public offering market and, to some degree, in the price of insurance.”); Dent, *supra* note 41; Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 976 (1993) (concluding, with respect to derivative and class action litigation, that “[t]he failure of prosecutors, regulators, and the courts to seek legal rules with bright lines also raises the cost of capital by generating costly litigation.”).

198. See *supra* note 191; Guido, *supra* note 195, at 506; see also O’Connor, *supra* note 75, at 366 (noting that the uncertain legal standards relating to materiality may cause defendants to settle). Although not the subject matter of this article, the large number of settlements of securities fraud class actions may have legal effects on issuers and insiders in addition to those provided for under the federal securities laws. For example, amounts payable by corporate defendants in settlement of a securities fraud claim are not dischargeable in bankruptcy. See 15 U.S.C. § 523(a)(19) (2000).

199. These factors may include (i) the possibility of a large judgment for the plaintiff class, (ii) a willingness to settle on the part of individual defendants, many of whom control the defendant corporation, (iii) the liability of third-party insurers for amounts paid in settlement of class actions, and (iv) the possibility that third-party insurers will be obligated to pay amounts in excess of policy limits if they reject settlements proposed by the parties. See Alexander, *supra* note 195, at 528-34, 548-68 (1991); see also Guido, *supra* note 197, at 506; Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003, 1006 (1998); Yablon, *supra* note 195, at 586 (suggesting that a substantial number of “longshot” securities class action claims, “coupled with litigation uncertainty, the availability of threshold motions to defendants,” and risk aversion by both sides provide, . . . the best explanation of “the high number, and low settlement value, of securities class actions.”).

200. See *Maley v. Del Global Tech. Corp.*, 186 F. Supp. 2d 358, 373 (S.D.N.Y. 2002) (“In the context of a complex class action, early settlement has far-reaching benefits in the judicial system.”); *Mashburn v. Nat’l Health Care, Inc.*, 684 F. Supp. 660, 669 (M.D. Ala. 1988) (“The law is clear that early settlements are to be encouraged.”).

201. To the extent that settlement amounts are covered by available insurance,

settlements, those who recover value as members of the plaintiff class typically receive an offsetting benefit, albeit less than the damages they are alleged to have suffered.<sup>202</sup> However, settlement amounts earmarked for distribution to the plaintiff class benefit only members of the plaintiff class; other investors suffer a loss of stockholder value arising from the fraud or the litigation itself and receive no compensation from the issuer.<sup>203</sup> This result is especially damaging to those who buy the issuer's securities before commencement of the class period and continue to hold the securities through the settlement payment date.<sup>204</sup>

If the issuer should decide to defend itself at trial rather than settle with the plaintiff class, the issuer then would be forced to shoulder other burdens. In addition to the operational costs resulting from the management distractions, outside counsel fees, and disbursements commonly associated with class action litigation (similar in effect and likely far greater in magnitude to those described above with respect to the materiality decision-making process), the prolonged period of uncertainty about the issuer's potential judgment liability during the pendency of the trial may tend to depress the overall market value of the firm.<sup>205</sup>

*B. Insider Trading Claims in the Securities Fraud Class Action Environment*

Suits alleging insider trading violations make up a significant number of the overall securities fraud class actions brought in any

---

the drain on stockholder value is lessened. *See, e.g.*, James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 25 ("Testimony that preceded the enactment of the Private Securities Litigation Reform Act estimated that 96 percent of securities class action settlements were for amounts within the limits of available insurance coverage."); Yablon, *supra* note 195, at 579-80 (noting that most securities class actions settle within applicable insurance policy limits). The issuer may, however, have to pay a higher premium or settle for lesser coverage after an insurer pays off all or part of a securities fraud class action settlement. *See* Alexander, *supra* note 197, at 581.

202. *See supra* note 185.

203. *See* Palmiter, *supra* note 195, at 83 ("The settlement of securities fraud class actions—the nearly universal outcome in these cases—involves payment by the company (existing shareholders) to the plaintiff class (a sub-group of existing or former shareholders) and to the plaintiff's lawyers."). These other investors may include both those who opt out of the plaintiff class and those who lack standing to be part of the plaintiff class because they did not purchase or sell securities during the class period. *See infra* note 204.

204. These stockholders cannot be members of the plaintiff class because they lack standing—they have not purchased or sold securities during the class period. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-32 (1975).

205. *See* W. Kip Viscusi, *Remarks of Featured Speaker, A Postmortem on the Cigarette Settlement*, 29 CUM. L. REV. 523, 545 (1998/1999) (noting similar effects in connection with suits against the cigarette industry).

given year and often are litigated as part of a larger action involving alleged corporate fraud.<sup>206</sup> Many factors contribute to this abundance of insider trading claims among the many securities class action lawsuits, including the ease with which alleged violations may be identified and the permissive nature of certain provisions in the Insider Trading and Securities Fraud Enforcement Act of 1988 (the "ITSFEA").<sup>207</sup>

Insider trading is a (relatively) easily identifiable type of securities fraud. This is because, under the "disclose or abstain" rule, the duty to disclose is triggered by the mere existence of a securities trade by the issuer or an insider, and the scienter requirement may be met by the mere decision to trade while in knowing possession of nonpublic information that is determined to be material.<sup>208</sup> Accordingly, the key fact in identifying a possible violation (other than the possession of material nonpublic information) is the existence of a trading transaction by the issuer or an insider. Existing public disclosure requirements under the 1933 Act and 1934 Act make the task of identifying trading transactions relatively easy.<sup>209</sup> Once potentially

---

206. Of the 224 securities class action filings made in 2002, 58 (or twenty-six percent) included claims of insider trading. See Cornerstone Research, *Securities Class Action Case Filings, 2002: A Year in Review*, available at Stanford Law School Securities Class Action Clearinghouse, *supra* note 27, at 17; see also Wager & Ward, *supra* note 39, at 17 ("More than 55 percent of new class action filings in 2001 contained allegations of improper trading by insiders . . .").

207. Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C. (2003)).

208. See *supra* notes 44 & 59 and accompanying text.

209. See generally *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 n.11 (1st Cir. 1999) (noting that "[b]ecause insiders of a publicly traded company must regularly file share ownership and trading reports with the SEC (on Forms 3, 4, 5, and 144), . . . information [regarding normal securities trading patterns] is readily available to plaintiffs."). After the end of each of its first three fiscal quarters (on Form 10-Q) and its fiscal year (on Form 10-K), each issuer with a class of equity securities registered under the 1934 Act must file with the SEC a periodic report that includes certain financial information about the corporation, including (among other things) specified financial statements for the issuer as at the end of that quarter or year. See 15 U.S.C. § 78m(a)(2) (2003). The year-end filing includes full, audited financial statements (including two years of balance sheet and three years of income statements, among other things) with footnotes. See 17 C.F.R. § 210 (2003). Accordingly, at or before the time of filing of the year-end report, the issuer would have publicly disclosed any sales or repurchases of its equity securities. Certain insiders also have to comply with disclosure requirements. Before selling equity in a corporation, certain officers, directors, and other persons controlling, controlled by, or under common control with the corporation must file a Form 144 to report future proposed sales of securities "if the amount of securities to be sold in reliance upon the rule during any period of three months exceeds 500 shares or other units or has an aggregate sale price in excess of \$ 10,000." See 17 C.F.R. § 230.144(h) (2003). Also, officers, directors, and beneficial owners of ten percent or more of a class of the corporation's equity securities registered under the 1934 Act must report certain information about most transactions in those securities after they occur—either by the end of the second business day following the day on which the transaction is

material nonpublic information has been identified, in many (if not most) circumstances, a prospective class action plaintiff or attorney can use these public filings to determine whether an issuer or insider may have traded while in possession of that information. Conversely, once a public filing has reported a proposed or actual trading transaction, a prospective class action plaintiff or attorney need only identify the issuer's or insider's awareness of potentially material nonpublic information in order to identify the key facts for its pleadings.

Congress also has given prospective plaintiffs a clearer path to private actions (including class actions) alleging insider trading violations. In 1988, with the adoption of the ITSFEA, persons engaging in trading transactions contemporaneous with insider trading acquired an express statutory right of action.<sup>210</sup> Within the first two years after adoption of the ITSFEA, one scholar noted the following as a plaintiff-oriented effect of this provision, among others: “. . . private attorneys . . . sue in those insider trading cases that promise ‘the largest judgment in the least amount of time.’”<sup>211</sup> One might reform this observation for purposes of the current class action environment by replacing the word “judgment” with the word “settlement.”

In this environment, then, many lawsuits alleging insider trading are brought and many of those are settled. Ambiguities in the existing materiality standard may make it more likely that an issuer or insider will want to settle with the plaintiff class early on (rather than suffer through a trial involving complex and uncertain elements of proof), especially with courts encouraging early settlements.<sup>212</sup> Moreover, long and protracted defenses of insider trading allegations have the capacity to distract management from the operations of the issuer and run up large legal costs, further impacting stockholder value.<sup>213</sup> Under these circumstances, plaintiffs are incentivized to bring insider trading class actions in circumstances where it is not clear—or even probable—that the nonpublic information possessed

---

executed (on Form 4) or by the 45th day after the end of the corporation's fiscal year in which the transaction occurred (on Form 5). See 17 C.F.R. § 240.16a-3 (2003). Finally, beneficial owners of five percent or more of a class of the corporation's equity securities registered under the 1934 Act must report material increases and decreases in that beneficial ownership promptly after they occur. See 17 C.F.R. § 240.13d-2(a) (2003).

210. 15 U.S.C. § 78t-1 (2003).

211. O'Connor, *supra* note 75, at 371.

212. See sources cited *supra* notes 198-200 and accompanying text (including data on the high rate of settlement of securities fraud class action litigation).

213. See Viscusi, *supra* note 205 and accompanying text.

by the trading issuer or insider is material.<sup>214</sup> Clearer materiality guidance should both limit this incentive to sue and make early dismissal of private insider trading actions more probable.

*C. The Need for Substantive Reform*

To date, general securities class action litigation reform largely has been procedural or quasi-procedural in nature.<sup>215</sup> The adopted reforms have not reduced the number or settlement value of securities class actions brought. It is time to give consideration to broad-based substantive reform to clarify U.S. insider trading regulation. This reform need not involve federal legislation and can be fashioned to have impact both in and outside the class action environment. The SEC's adoption of Rule 10b5-1 and Rule 10b5-2 in the summer of 2000 represents a step in this direction in the context of U.S. insider trading regulation.<sup>216</sup> Why not continue along these lines by providing enhanced guidance on materiality in that context?

As noted above, greater clarity in defining materiality logically should cause a reduction in the number of insider trading class actions filed or should result in the dismissal of more of these cases on a pretrial motion. Specifically, after the adoption of effective materiality guidance, a class action based on the failure by an issuer or insider to disclose nonpublic information in connection with a

---

214. Of course, the plaintiff's access to the courts is not wholly unfettered. Counsel to the plaintiff class must act in accordance with all applicable rules of attorney conduct and professional responsibility in bringing and settling any insider trading litigation.

215. There are certain notable exceptions, however. Professor Leubsdorf summarized the overall landscape in this area as follows:

Although class action law is moving in substantive directions, procedure may still have a hand on the wheel. Often, indeed, it is hard to separate changes in substantive law from class action changes, particularly in areas where class actions have become the predominant remedy. . . . The "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 contain no procedural or remedial clauses, but would they have been enacted without the growth in securities class action that made securities litigation important to corporate management?

The congressional origin of most class action changes links with their substantive impetus. Procedural rulemakers have continued to write general, transsubstantive rules. Because so many groups have conflicting interests in class action rules, no consensus supporting significant class action changes of transsubstantive impact has arisen. Interest groups seeking narrower changes have found Congress a more receptive audience whether the changes they sought were substantive, procedural, or both.

John Leubsdorf, *Class Actions at the Cloverleaf*, 39 ARIZ. L. REV. 453, 455 (1997) (footnotes omitted). An important recent procedural reform impacting securities fraud class actions, including actions alleging insider trading, is the extension of the statute of limitations for Rule 10b-5 actions (among others) enacted as part of Sarbanes-Oxley. See 28 U.S.C. § 1658(b) (2003).

216. See *infra* note 219.

purchase or sale of securities would survive a motion to dismiss or for summary judgment (if any) if the undisclosed nonpublic information is material under new, more precise guidance. Similarly, after adoption of effective materiality guidance, a defendant should be able to prevail on a motion to dismiss or for summary judgment if any and all undisclosed information in the possession of the subject issuer or insider is immaterial under that definition. Yet, certain actions would survive summary judgment and still not result in a materiality ruling favoring the plaintiffs. That is because it is impossible to achieve complete legal certainty and predictability of end results at this stage in the proceedings— except under a bright-line rule (which is not being advocated here).<sup>217</sup> However, by enhancing certainty and predictability of result, effective materiality guidance may result in fewer insider trading class action settlements, and the value of any settlements should better reflect actual, rather than speculative (or nuisance), measures of value.

Of course, where definitions important to a rule of law are clarified, unintended loopholes are likely to be identified and exploited by those who desire to push that rule of law to its logical— or illogical—extreme. Nevertheless, the benefits of clarity to transaction planners, litigants, and courts outweigh this possible detriment.<sup>218</sup> Moreover, a thoughtful, careful decisional and drafting process to more precisely define materiality should minimize this detrimental effect.

## VI. A PROPOSAL

Fair and honest securities markets, investor confidence in those markets, and accurate and complete public disclosure in the insider trading regulation context can be enhanced by the adoption of more precise guidance as to information that is material. Whether that guidance comes in the form of legislation, SEC rulemaking, SEC

---

217. See *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988).

218. In this regard, on a more general note, Professor Grzebielski observed that: while rules perhaps cannot define precisely what does and does not violate the law, a greater specific content can be given through them than by relying on the provisions of ubiquitous rule 10b-5. The expansive interpretations which the courts and the Commission have often afforded rule 10b-5 permit its use to reach almost any conduct related to the purchase or sale of securities that is deemed unfair. If rule 10b-5 is to be a catchall, it should be used to reach conduct not already specifically regulated, rather than to swallow up the entire field.

Ray J. Grzebielski, *A Response to Roberta Karmel's Call for a New Direction in Federal Securities Regulation: Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America*, 57 TUL. L. REV. 930, 937 (1983).

interpretive advice, or (at a bare minimum) more methodical, rigorous decision making in the courts, enhanced guidance is warranted.<sup>219</sup> The question then becomes how those guidelines should be constructed.

A. *Suggested Approach to Fashioning Appropriate Materiality Guidance*

In fashioning materiality guidance, it is important first to determine the specific objective to be served by that guidance. The factual scenarios in which an issuer or insider may trade securities while in possession of nonpublic information are limitless. Accordingly, it is unrealistic (and arguably undesirable<sup>220</sup>) to expect to fashion guidance that authoritatively defines what is "material" for every possible set of facts in every possible subject matter area in the insider trading context. An alternative goal, not inconsistent with the PSLRA, is to fashion guidance designed to afford both private investors (as prospective private action plaintiffs) and issuers and their insiders (as putative defendants) more clarity and certainty. Specifically, this guidance would aid litigants and their counsel in determining whether to bring and how to respond to complaints, motions to dismiss, or motions for summary judgment based on knowledge of recurring fact patterns in key subject matter areas. This objective is both attainable and useful to litigants and others in addressing the identified disadvantages associated with the current lack of clarity and precision in determining materiality.<sup>221</sup>

---

219. A separate article could be written about the benefits and detriments of each possible legislative, administrative, and judicial approach to formulating and issuing guidance on materiality in the insider trading context. That scholarly work, which logically would integrate principles of legislation, administrative law, and jurisprudence (among other disciplines), must be left for another day. Even without the benefit of that further analysis, however, one logically might place the initial responsibility for this effort in the hands of the SEC for two reasons. First, the SEC has express authority to adopt regulations under Section 10(b) of the 1934 Act. See 15 U.S.C. § 78j(b) (2003). Second, the SEC recently has issued specific guidance on other definitional issues in the insider trading area through its adoption of Rule 10b5-1 and Rule 10b5-2. See 17 C.F.R. § 240.10b5-1 (2003); 17 C.F.R. § 240.10b5-2 (2003). The proposal forwarded in this Part represents a logical extension of these earlier SEC initiatives.

220. Bright-line tests may limit the ability of private and public enforcement to adapt to new circumstances, sealing off opportunities to proscribe or punish conduct that, while not foreseen, is intended to be regulated. The *Basic* Court, for example, did not find much merit in the arguments favoring a bright-line test for materiality. See *Basic*, 485 U.S. at 236.

221. Despite the litigation-oriented nature of this objective, guidance fashioned along these lines should be useful to transaction planners, enforcement agents, and judges, as well as litigation counsel, since it more directly focuses both *ex ante* and *ex post* factual inquiries and analyses.



1. *Recognizing the “disclose or abstain” rule for what it is*

In sum and substance, the “disclose or abstain” rule governing insider trading under Rule 10b-5 functions as a transaction-triggered mandatory disclosure rule without any existing line-item content guidance.<sup>222</sup> Said another way, issuers and insiders know that they must disclose all material nonpublic information then in their possession, but there are no content-oriented disclosure rules directly applicable to their disclosure obligation (as there are with respect to other transactional disclosure rules relating to, for example, public offerings and federally regulated tender offers). Accordingly, it seems logical to approach the task of issuing materiality guidance in the insider trading context as one would approach materiality guidance in the context of any line-item mandatory disclosure rule.<sup>223</sup> The process of constructing materiality guidance logically involves, for each subject matter area or factual context in which guidance is to be provided, the identification of the elements of materiality in that subject matter area or factual context in the insider trading environment, and a recognition of the ways in which the materiality of specific information in that area or context and that environment can be measured. Each materiality element and method of measurement then would be incorporated into guidance on materiality for that subject matter area or factual context.

2. *An existing regulatory example*

The materiality elements and measuring methods used in existing mandatory disclosure rules are best illustrated by an example. Item 11(c) of Form S-1<sup>224</sup> calls for the disclosure of “legal proceedings” in accordance with Item 103 of Regulation S-K (“Item 103”) in connection with a public offering of securities.<sup>225</sup> In that connection,

---

222. See *supra* note 29. After significant guidance is created around specific categories of material information, it may make sense to collect that guidance in an SEC-promulgated disclosure document designed to allow issuers or insiders to report material information in connection with a corporate or insider trading transaction that is not otherwise reported under existing SEC rules and regulations. See *supra* note 209 (summarizing briefly certain existing SEC rules and regulations governing disclosure responsibilities).

223. See Franco, *supra* note 142. This approach to constructing materiality guidance (and, in fact, the desirability (regarding information about the interaction of mandatory disclosure rules and antifraud provisions) and efficacy of enhanced materiality guidance of any form) rests, in part, on arguments supportive of mandatory disclosure rules under the securities laws as a whole.

224. See Securities Act Form S-1, 17 C.F.R. § 239.11 (2002), available at <http://www.sec.gov/divisions/corpfin/forms/s-1.htm> (last visited July 7, 2003). Form S-1 is the basic registration form under the 1933 Act that is generally used when no other form is available.

225. See 17 C.F.R. § 229.103 (2003). The text of the rule consists of the following

the instructions to Item 103 offer guidance as to what is material.<sup>226</sup> The three key elements of materiality identified in those instructions include: (i) the extent to which the proceeding typically accompanies the issuer's business; (ii) the financial effect on the issuer of a damages claim; and (iii) the substantive nature of the proceeding.

Methods for measuring materiality vary from element to element. For example, as to typicality, Instruction 1 to Item 103 advises the issuer that no action for negligence or other claim ordinarily resulting from the business of the issuer is required to be described "unless it departs from the normal kind of such actions."<sup>227</sup> As to the financial effect on the issuer of a damages claim, Instruction 2 to Item 103 states that the issuer need not disclose information about a proceeding if the proceeding "involves primarily a claim for damages" and "the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets" of the issuer and its subsidiaries on a consolidated basis.<sup>228</sup> The issuer must aggregate the amount involved in all proceedings presenting "the same legal and

---

brief mandate:

Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

*Id.* In explaining the use of materiality in this and other mandatory disclosure rules, one scholar states:

[W]hile Regulation S-K identifies specific information to be disclosed, in many cases that information is further "filtered" through the screen of materiality. So, for instance, in describing the legal proceedings facing a company under Item 103, issuers are required to "[d]escribe briefly any *material* pending legal proceedings, other than ordinary routine litigation incidental to the business . . . ." The instructions to Item 103 further (and helpfully) set out a materiality benchmark of 10% of the current assets of the issuer, except in an environmental proceeding against a government entity, in which case proceedings with the possibility of a \$100,000 fine must be disclosed. When the regulation does not specifically provide a materiality benchmark, the general materiality standard prevails. Under this general standard, information is defined as material if there is a substantial likelihood that a reasonable investor would deem the information significant in the total mix of available information. Thus, Regulation S-K defines an issuer's disclosure obligations generally, as filtered through the "materiality" screen.

Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1209 (1999) (footnotes omitted).

226. See 17 C.F.R. § 229.103 (2003); see Williams, *supra* note 225.

227. 17 C.F.R. § 229.103 (2003).

228. *Id.*

factual issues” for calculation purposes.<sup>229</sup> Finally, Instructions 3, 4, and 5 to Item 103 highlight for consideration three types of legal proceedings garnering special attention in making materiality determinations under Item 103:

- (x) material bankruptcy, receivership, or similar proceedings;
- (y) material proceedings to which any director, officer, affiliate, or five-percent beneficial owner of the issuer, or any associate of any of the foregoing,
  - (i) is a party adverse to the issuer or a subsidiary of the issuer or
  - (ii) has a material interest adverse to the issuer or a subsidiary of the issuer; and
- (z) environmental proceedings.<sup>230</sup>

Notwithstanding Instructions 1 and 2 to Item 103, the proceedings described in items (x) and (y) are required to be disclosed.<sup>231</sup> Proceedings described in item (z) are required to be disclosed based on the existence of any one of three alternative states of facts:

- (1) the materiality of the proceeding to the issuer’s business or financial condition;
- (2) the magnitude of the damages claim (in a damages suit), monetary sanctions, capital expenses, deferred charges, or charges to income to which the issuer may be subject, based on the same percentage-of-assets test articulated in Instruction 2 of Item 103; or
- (3) the issuer’s belief as to the magnitude of monetary sanctions, exclusive of interest and costs, that may be assessed against the issuer in a proceeding or group of proceedings to which a governmental authority is a party.<sup>232</sup>

---

229. *Id.*

230. *Id.* Unfortunately, in defining material legal proceedings, these instructions use the word “material” without defining it. See Joel Seligman, *The SEC’s Unfinished Soft Information Revolution*, 63 *FORDHAM L. REV.* 1953, 1965 (1995) (noting that materiality is not defined in Item 103). At best, the use in a definition of an ill-defined term that is, itself, part of the term being defined apparently violates a tried-and-true rule of writing typically taught to students in U.S. primary and secondary schools: In defining a term, never use the term itself in the definition. See Renah R. Holmes, *First Amendment Rights: May A School Ban Religious Symbols that Are Arguably Gang-Related?*, 27 *J.L. & EDUC.*, 511, 514, 515 (1998) (noting a court’s application of this rule). Although “material” is used in these instructions to modify a narrower category of information than “litigation” (i.e., bankruptcy, receivership, and self-dealing proceedings), this approach has little to recommend to it in terms of clarity and precision.

231. 17 C.F.R. § 229.103 (2003).

232. *Id.* (using, again, the term “material” in the instructions); see Williams, *supra* note 225 (detailing the role of materiality in the disclosure of legal proceedings).

Although the materiality inquiry under Item 103 for purposes of the Form S-1 registration statement does not end here;<sup>233</sup> the instructions to Item 103 provide important materiality guidance to transaction planners, litigants, and courts in the context of the rule.

3. *Defining the key elements of materiality and methods of measurement in the insider trading context*

Unlike Item 103 (which references material legal proceedings), the insider trading “disclose or abstain” rule references a significantly more amorphous and wide-ranging area for disclosure—material nonpublic information. Accordingly, identifying the key elements of materiality applicable to specific subject matter areas or factual context in the insider trading contexts is a more difficult, broad-based task. The key operative question in each subject matter area or factual context derives from the applicable legal standard: what types of undisclosed information about the issuer is a reasonable investor substantially likely to find important in making an investment decision with respect to an issuer’s securities at a time when the issuer or one of its insiders is permitted to trade in the issuer’s securities? A number of common, general elements quickly come to mind. These include: (a) the actual or potential impact of the information on the financial condition or results of operations of the issuer (“financial impact”);<sup>234</sup> (b) the actual or potential impact of the information on the business or operations of the issuer, including the actual or potential impact of the information on the management of the issuer (“operational impact”);<sup>235</sup> and (c) the age or currency of the

---

233. The instructions to Item 103 are not exclusive. For example, a third-party non-environmental action for negligence or other claim not ordinarily resulting from the business of the issuer is not necessarily material (and need not be disclosed), even if the amount in controversy exceeds ten percent of the current assets of the issuer. Materiality also has a general meaning in the context of these mandatory disclosure rules that is codified in the rules and regulations under the 1933 Act. See 17 C.F.R. § 230.405 (2003) (defining materiality for required disclosures under the 1933 Act); *id.* § 240.12b-2 (2003) (giving the same definition of materiality for required disclosures under the 1934 Act). Moreover, both the 1933 Act, as pertains to registration statements, and the 1934 Act, as pertains to periodic and current reports or transaction disclosure statements, require disclosure of any material information not expressly called for by line-item disclosure rules if “necessary to make the required statements, in the light of the circumstances under which they were made, not misleading.” See 17 C.F.R. § 230.408 (2003); *id.* § 240.12b-20 (2003).

234. See Fedders, *supra* note 13, at 41 (noting that materiality on the basis of financial impact is commonly referred to as “quantitative materiality”); Seligman, *supra* note 230, at 1965 (“The concept of quantitative materiality typically involves a percentage of a corporation’s assets, earnings, sales, or other numerical benchmarks.”).

235. See Fedders, *supra* note 13, at 41 (illustrating quantitative materiality by reference to management or other operational effects); Seligman, *supra* note 230, at

information (“informational currency”).<sup>236</sup> In specific subject matter areas or factual contexts, one or more of these elements may be important; some almost necessarily overlap.<sup>237</sup> This is a useful, albeit general, list of elements to consider in beginning to fashion appropriate materiality guidance.

The method for measuring materiality based on each applicable element also may vary with the specific subject matter area or factual context in which materiality is being determined. For example, certain measures of financial impact may relate principally to effects on an issuer’s balance sheet, and not its income statement.<sup>238</sup> Any measurement method, however, must comply with existing statutory and decisional law, as well as applicable rules and regulations. Accordingly, among other things, the measurement method must be objective; it must measure, in some way, the importance of the information to the reasonable investor.<sup>239</sup>

There exist a number of sources for applicable elements of materiality and methods of measurement that are instructive in creating more precise materiality guidance in the insider trading context. Because insider trading regulation under Rule 10b-5 relates to the need for disclosure in connection with the purchase or sale of a security, line-item disclosure rules already adopted by the SEC for use in the context of purchases or sales of securities represent a key (if somewhat generic) source of materiality guidance.<sup>240</sup> For example,

---

1965 (noting as examples of qualitative materiality “matters such as managerial conflicts of interest or violations of law”).

236. See, e.g., 17 C.F.R. §§ 229.301-229.303 (2002) (detailing various time requirements applicable to the disclosure of specified financial information).

237. For example, operational impact frequently (but not always) will be accompanied by actual or presumed financial impact. See SEC Staff Accounting Bulletin No. 99, *supra* note 32; see also Miller, *supra* note 26, at 383 (“SAB No. 99 demands that auditors use qualitative elements to illuminate and expand the traditional quantitative materiality analysis, not undertake a qualitative analysis completely divorced from the quantitative analysis.”).

238. See, e.g., *supra* note 223 and accompanying text (discussing the asset test under Regulations S-K Item 103).

239. See, e.g., *supra* note 66 and accompanying text.

240. In point of fact, the line-item mandatory disclosure rules are both under-inclusive and over-inclusive. See Bainbridge, *supra* note 2, at 1056-57. Cf. Steven G. Sanders, Comment: *Line-Item Disclosure Provisions and the Materiality of Preliminary Merger Negotiations After In re George C. Kern, Jr.*, 59 BROOK. L. REV. 175, 234 (1993) (noting that “mandatory disclosure requirements . . . do not predicate disclosure upon materiality”). On the one hand, required disclosures may be insufficient in conveying all material facts, as determined under existing law, about a particular matter; more information may need to be disclosed to satisfy materiality requirements. See Brian Neach, Note, *Item 303’s Role in Private Causes of Action Under the Federal Securities Laws*, 76 NOTRE DAME L. REV. 741, 770-73 (2001) (explaining a presumption, expressed in cases and other legal resources, that the information required to be disclosed under line-item disclosure rules is material); Franco, *supra* note 142, at 291-92 (“[M]andatory disclosure makes antifraud regulation more

disclosure rules for issuer-tender offers (purchases by the issuer of its own securities) can be instructive with respect to issuer or insider purchase transactions. Moreover, disclosure rules relating to public or private offerings of securities may be helpful in determining materiality in the context of issuer or insider securities dispositions. Line-item disclosure rules applicable to periodic reporting and other statutory and regulatory reporting requirements (e.g., Form 144 under Rule 144 under the 1933 Act, and reports on Forms 3, 4, and 5 under Section 16(a) of the 1934 Act)<sup>241</sup> also may be instructive under certain circumstances because they are intended to effectively inform market participants of important information regarding the trading of issuers and insiders in an issuer's securities.<sup>242</sup>

Existing decisional law is another valuable source for more concrete materiality measurement principles. For example, certain

---

potent as a signaling mechanism by establishing a minimum disclosure floor-affirmative disclosure requirements . . ."). This has been true, for example, in the area of required management disclosures of prior legal proceedings under Item 401(f) of Regulation S-K. 17 C.F.R. 229.401(f) (2003). See *Haskell v. Wilson*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,543 (E.D. Pa. 1991) (finding fifteen year-old securities violations material where line-item disclosure requires a five-year look-back); *Bertoglio v. Tex. Int'l Co.*, 488 F. Supp. 630, 661 (D. Del. 1980) (reasoning that a history of violations are material because of their chronic nature, even if these violations are fifteen years old); Securities Act Release No. 5,758, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,783, at 87,031 (Nov. 2, 1976) (averring that events occurring outside the five-year disclosure period "may be material and should be disclosed"). But see *SEC v. Goldfield Deep Mines Co.*, 758 F.2d 459 (9th Cir. 1985) (finding no violation of Section 13(a) of the 1934 Act where the registrant failed to disclose a seventeen-year old embezzlement conviction and a just-more-than five-year-old securities violation). The "gap-filler" materiality rules under the 1933 Act and the 1934 Act expressly recognize that the line-item disclosure rules may not call for the disclosure of all material information. See 17 C.F.R. § 230.408 (2002); 17 C.F.R. § 240.12b-20 (2002). On the other hand, certain line-item disclosure rules may compel disclosure of facts beyond those that are material for Rule 10b-5 purposes. See *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000) (regarding Item 303 of Regulation S-K); *Natural Resources Defense Council, Inc. v. SEC*, 432 F. Supp. 1190, 1200 n.26 (D.D.C. 1997) (noting the SEC's authority "to require registrants to disclose 'nonmaterial' but economically significant information."); John W. Bagby et al., *How Green was My Balance Sheet?: Corporate Liability and Environmental Disclosure*, 14 VA. ENVTL. L.J. 225, 271 (1995) (noting that critics of the SEC's environmental disclosure rules believe that they require disclosure of immaterial information); Sanders, *supra* note 240, at 217 n.207 (indicating that the SEC may require disclosure of information that is immaterial). This under- and over-inclusiveness may be the inevitable result of the generic, one-size-fits-all manner in which mandatory disclosure rules are drafted. See generally Sanders, *supra* note 240, at 209-23 (1993) (providing an interesting, albeit somewhat dated, discussion of the interplay between mandatory disclosure rules and materiality in a specific context).

241. See *supra* note 30.

242. See *supra* note 29 and accompanying text (contending that the regulation of insider trading under Rule 10b-5 is a form of disclosure regulation); see also *supra* notes 151 & 153 and accompanying text (noting that unregulated insider trading may lead to greater accuracy in the market price of securities).

fact patterns repeat themselves in cases decided by a number of different federal district or circuit courts.<sup>243</sup> These courts may have identified applicable materiality elements and used methods of measurement that Congress, the SEC, or other courts can use in providing more specific advice on materiality. The areas of materiality analysis in which these common fact patterns arise represent excellent choices for subject matter areas in which more precise materiality guidance should be given.

Once information is assembled in a particular subject matter area regarding the appropriate measures and elements of materiality, the author of the guidance (whether that be Congress, the SEC, or the courts) may avail itself of this information to better define materiality using, for example, rebuttable presumptions or *per se* rules regarding materiality or immateriality.<sup>244</sup> The nature and quality of the guidance that can be provided necessarily may be limited in some respects by materiality interpretations under existing law and regulation, except where the authority issuing the guidance chooses to exercise the authority to overrule that law or regulation (as applicable).

#### B. *Application of the Suggested Approach to the Two Examples*

To illustrate the operation of this suggested approach to fashioning materiality guidance, let us return to the two examples set forth in Part II.A of this Article. Applying the suggested approach, Congress, the SEC, or the courts could provide clearer and more precise materiality guidance useful in each of the subject matter areas represented by the examples.<sup>245</sup>

---

243. See *supra* note 48 (noting that the examples presented and analyzed *supra* Part II, and also used *infra* part VI.B, have been chosen, in part, for their typicality).

244. Although it is easy to see how the clarity of *per se* rules could positively impact stockholder value, it may be harder to understand how presumptions could be similarly beneficial. To obtain the level of precision needed to warrant the cost associated with *ex ante* regulation, any presumptions associated with materiality guidance must be accompanied by specific factors allowing for rebuttal of those presumptions. The proposal set forth in this article incorporates this principle as an essential element.

245. The application of the suggested approach to the two examples set forth in this article is not intended to provide complete, final guidance, but rather a preliminary basis for thought and discussion on appropriate guidance. As such, many details, including those relating to the precise manner in which quantitative and qualitative measures of materiality might be integrated, remain to be determined. The specific illustrations should provide those who favor enhanced materiality guidance with a tangible foothold in accomplishing their objectives—a framework that gives legislators, regulators, and the judiciary an incentive to proceed. Even if the application of the suggested drafting approach to the examples does not meet these lofty objectives, at the very least, consideration of these illustrations, by reference to existing mandatory disclosure rules, enables us to take

1. *Example #1—Improper balance sheet accounting*

The Corporation in Example #1 has overstated its assets by an amount equal to two percent of its total assets because its booked reserves were inadequate. This information was not publicly available at the time the CFO sold the Corporation's securities; however, this information was or should have been known to the CFO at the time of the sale transaction. Example #1 relates primarily to financial impact and, more specifically, a misstatement on the Corporation's balance sheet. Reserves are understated, so assets are correspondingly overstated. Other financial statements, we shall assume, are not significantly impacted by this misstatement.<sup>246</sup>

Precise guidance on the method of measuring the materiality of misstatements of or changes in assets is not widespread in the mandatory disclosure rules. Since the release of SAB No. 99,<sup>247</sup> however, it has been clear that, in determining the materiality of financial misstatements, "quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations."<sup>248</sup> Specifically, SAB No. 99 references the acknowledged use of a five-percent quantitative threshold used by accountants and executive officers prior to the adoption of SAB No. 99. Omissions and misstatements under that threshold amount were, according to SAB No. 99, routinely determined to be *per se* immaterial "in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management."<sup>249</sup> SAB No. 99 rejects that approach to determining materiality in favor of a combined quantitative and qualitative analysis, but SAB No. 99 does not provide details on the substance of that combined analysis. SAB No. 99 does include a list of relevant qualitative considerations,<sup>250</sup> several of which are or may

---

another hard look at the sufficiency of existing mandatory disclosure rules in transactional and periodic reporting.

246. In an effort to prevent this part of the article from resulting in a detailed accounting analysis, an overly simplistic asset-oriented fact pattern has been chosen as a basis for Example #1. An adjustment to the Corporation's income statement likely would be made as a result of corrections to be required to be made to the Corporation's balance sheet; however, the reader is asked to assume that the income statement adjustment would represent a *de minimis* change to the Corporation's revenues.

247. See generally SEC SAB No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999) (referenced at 17 C.F.R. pt. 211).

248. *Id.* at 45,151.

249. *Id.*

250. See *id.* at 45,152. In this regard, SAB No. 99 states as follows:

Among the considerations that may well render material a quantitatively



be present here,<sup>251</sup> but the list is nonexclusive and the various listed considerations are not weighted in terms of their significance to the overall materiality determination. Accordingly, SAB No. 99 does not provide sufficient guidance in determining the materiality of the Corporation's failure to properly account for its reserves and assets.

Several important asset-based touchstones do exist, however. Item 2 of Form 8-K under the 1934 Act mandates disclosure of certain information regarding the acquisition or disposition by the registrant of "a significant amount of assets, otherwise than in the ordinary

---

small misstatement of a financial statement item are—

- Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate.
- Whether the misstatement masks a change in earnings or other trends.
- Whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise.
- Whether the misstatement changes a loss into income or vice versa.
- Whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability.
- Whether the misstatement affects the registrant's compliance with regulatory requirements.
- Whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements.
- Whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation.
- Whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement. Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material . . . . When . . . management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.

*Id.* (footnotes omitted). This list and commentary can be incorporated into more specific materiality guidance in the insider trading context, as needed. The SEC later issued further non-specific materiality guidance that also may be of some help to issuers and insiders. The SEC's release concerning Regulation FD includes a nonexclusive list of events, circumstances, and information that may be material. *See* Selective Disclosure and Insider Trading, *supra* note 32.

251. For example, the facts of Example #1 raise the possibility that (i) the misstatement arises from an estimate, requiring an assessment of the degree of imprecision inherent in the estimate, (ii) the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability, and (iii) the misstatement has the effect of increasing management's compensation by increasing the value of the employee stock options exercised by the CFO.

course of business.”<sup>252</sup> Instruction 4 to Item 2 of Form 8-K informs us that an acquisition or disposition involves “a significant amount of assets (i) if the registrant’s and its other subsidiaries’ equity in the net book value of such assets or the amount paid or received therefore . . . exceeded 10 percent of the total assets of the registrant and its consolidated subsidiaries, or (ii) if it involved a business . . . which is significant . . . [under paragraphs (b) and (d) of Item 11-01 of Regulation S-X].”<sup>253</sup> If these mandatory disclosure rules only require interim public disclosure of dispositions of more than ten percent of a registrant’s assets, why should we require interim public disclosure of a decrease in two percent of the Corporation’s total assets in the insider trading context posited by Example #1? Materiality guidance in the context of insider trading should at least take into account the measurement of asset significance in the Form 8-K filing requirement, or consideration must be given to the modification of that requirement.

In addition, Item 404 of Regulation S-K mandates disclosure of transactions between an issuer and any director nominee or current director of the issuer, where the “nominee or director is, or during the last fiscal year has been, an executive officer of, or owns, or during the last fiscal year has owned, of record or beneficially in excess of ten percent equity interest in, any business or professional entity to which the registrant or its subsidiaries was indebted at the end of the registrant’s last full fiscal year in an aggregate amount in excess of five percent of the registrant’s total consolidated assets at

---

252. SEC Form 8-K, 17 C.F.R. § 249.308 (2003), available at <http://www.sec.gov/divisions/corpin/forms/8-k.htm>. In general, Form 8-K requires disclosure of asset dispositions at this level. A registrant may voluntarily disclose a disposition of assets at a lower level of financial significance under Item 5 of Form 8-K.

253. *Id.* Item 11-01 of Regulation S-X requires the presentation of *pro forma* financial information: (i) in the event of the acquisition of a business constituting, among other things, more than twenty percent (based either on investments in and advancements to the business or on a proportionate share of the total assets of the business) of the total consolidated assets of a registrant and its subsidiaries as of the end of the most recently completed fiscal year; or (ii) in the event of the disposition of a business constituting ten percent (based either on investments in and advancements to the business or on a proportionate share of the total assets of the business) of the total consolidated assets of a registrant and its subsidiaries as of the end of the most recently completed fiscal year. See 17 C.F.R. § 210.11-01(b), (d) (2003); 17 C.F.R. §§ 210.1-02(w)(1)-(2) (2003). The ten percent tests derive from the definition of “significant subsidiary” in Regulation S-X. See 17 C.F.R. § 210.1-02(w) (2003). The term “significant subsidiary” is also used and defined in the rules and regulations under the 1933 Act and 1934 Act. See 17 C.F.R. §§ 230.405, 240.12b-2 (2003). These “significant subsidiary” definitions also include a ten percent income statement test not referenced here (because Example #1, on its facts, raises no significant income statement issues). See 17 C.F.R. §§ 210.1-02(w)(3), 230.405, 240.12b-2 (2003).

the end of such fiscal year.”<sup>254</sup> Under this disclosure rule, a liability in excess of five percent of assets is deemed significant under circumstances that indicate insider self-interest.<sup>255</sup>

Existing decisional law also can play an important role in crafting more precise materiality guidance applicable to Example #1. As noted above, the facts in Example #1 are based in part on the facts found by the court in *Parnes v. Gateway 2000, Inc.*<sup>256</sup> In that case, the court upheld a Rule 12 dismissal of the action because, among other things, a two-percent overstatement of assets in connection with a “high risk/high yield investment opportunity in a company with a history of very rapid growth” was not material as a matter of law because disclosure of the overstatement would not have significantly altered the total mix of information available to investors.<sup>257</sup> The court also relied on the “bespeaks caution” doctrine in rendering its judgment on materiality.<sup>258</sup> *Parnes* has been cited with approval on this point, with specific reference to the two-percent asset overstatement.<sup>259</sup>

Based on the foregoing materiality guidance on improper balance sheet accounting, could be constructed so that it: (i) renders *per se* material all asset or liability omissions or misstatements in amounts exceeding ten percent of an issuer’s total consolidated assets (taken individually or collectively for any given reporting period), based on the most recently reported balance sheet of the issuer; (ii) presumes material all asset or liability omissions or misstatements in amounts exceeding five percent (but not in excess of ten percent) of an

---

254. 17 C.F.R. § 229.404(b)(3) (2003).

255. *See id.* In the insider trading context, it may fairly be said that self-interest always exists because of the issuer’s or insider’s involvement in a securities trading transaction. *See Langevoort, supra* note 131, at 1328 (“Because the riches from insider trading can be so great and the opportunity to ‘pull it off’ otherwise so simple for those with special access to sensitive information, insider trading poses *the* quintessential temptation in a larger company to pursue self-interest rather than stay in role as a habitually virtuous fiduciary.”).

256. 122 F.3d 539 (8th Cir. 1997).

257. *See id.* at 546-48 (noting “[t]here are a variety of reasons why an alleged misrepresentation or omission may, as a matter of law, be immaterial” and citing to some of those reasons).

258. *See id.* at 548-49. The “bespeaks caution” doctrine permits the court to render immaterial any statement that is accompanied by specific, meaningful cautionary language. *Id.* at 548.

259. *See Romine v. Acxiom Corp.*, 296 F.3d 701, 706 (8th Cir. 2002) (“In *Gateway 2000*, we upheld a Rule 12 dismissal because a two percent overstatement of assets by a high-risk/high-yield investment opportunity would not have significantly altered the total mix of information available to a reasonable investor.”); *see also Blatt v. Muse Techs., Inc.*, Nos. Civ.A. 01-11010-DPW, Civ. A. 01-12173-DPW, 2002 WL 31107537, \*30 (D. Mass. Aug. 27, 2002) (citing to *Parnes* and including a parenthetical reference describing the basic facts and resolution of the case).

issuer's total consolidated assets (taken individually or collectively for any given reporting period), based on the most recently reported balance sheet of the issuer (which presumption is rebuttable by the trading issuer or insider based on a list of specified factors derived from current law and regulation); and (iii) presumes immaterial all asset or liability omissions or misstatements in amounts equal to or less than five percent of an issuer's total consolidated assets (taken individually or collectively for any given total reporting period), based on the most recently reported balance sheet of the issuer (which presumption is rebuttable by an investor plaintiff or prosecutor based on a list of specified factors derived from current law and regulation).<sup>260</sup>

2. *Example #2—Failed merger discussions*

Example #2 raises issues of financial impact, operational impact, and informational currency, all in one factual package. Specifically, the facts of Example #2 relate to trading in Target's securities by directors of Target in light of undisclosed past, spurned offers made by Acquiror for the acquisition of Target. All acquisitions, as extraordinary corporate transactions, have an undeniable (even if unpredictable and, in some cases, indefinable) effect on the financial condition and results of operations of the acquisition target and the business and operations of that target; including the continued engagement and employment of the target's management.<sup>261</sup> Accordingly, the existence of a plan, proposal, discussion, or negotiation relating to or resulting in an issuer's acquisition is always a matter for serious consideration by transaction planners and courts under the *Basic* "probability versus magnitude" test.<sup>262</sup>

---

260. This list of factors should take into consideration, for example, the factors set forth in SAB No. 99. *See supra* note 250. Admittedly, reliance on a rebuttable presumption of immateriality, at any threshold level, may appear inconsistent with SAB No. 99, in that SAB No. 99 requires that all materiality determinations be made based on both quantitative and qualitative criteria. *Id.* However, the referenced lists of factors will permit (and are designed to compel) consideration of tailored qualitative criteria.

261. *See SEC v. Geon Indus., Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976) ("Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.").

262. *See Kitch, supra* note 61, at 823. Professor Kitch notes that:

In the insider-trading context, it is inconceivable with respect to negotiations, specifically, that the Court would hold that merger negotiations were not material. The issue is whether an insider, knowing that merger negotiations were underway and looking to the consummation of a merger at a significant premium over the price of the issuer's stock, could

Of course, where a target corporation is engaging in transaction planning in the wake of a mere proposal for an acquisition, even if made at a specific price, the financial impact and operating impact of the proposal and any subsequent acquisition are highly speculative and difficult to measure. Existing disclosure rules in this area measure the need for disclosure first by focusing primarily on the type of transaction proposed. For example, under Item 1006(c)(1) of Regulation M-A,<sup>263</sup> referenced in Item 6 of Schedule TO,<sup>264</sup> an issuer engaging in an issuer tender offer<sup>265</sup> must “describe any plans, proposals or negotiations that relate to or would result in . . . [a]ny extraordinary transaction, such as a merger, reorganization or liquidation. . . .”<sup>266</sup> Similarly, Item 1005(b) of Regulation M-A,<sup>267</sup> as incorporated into Item 5 of Schedule TO,<sup>268</sup> requires that a third-party tender offeror disclose “any negotiations, transactions or material contacts during the past two years between the filing person [offeror] . . . and the subject company [target] or its affiliates concerning any (1) [m]erger; (2) [c]onsolidation; (3) [a]cquisition; (4) [t]ender offer for or other acquisition of any class of the subject

---

proceed to purchase shares of the issuer on the market. Obviously not, because the fact of merger negotiations is the kind of confidential material that insiders should not be permitted to exploit for their own gain.

*Id.*

263. 17 C.F.R. § 229.1006(c)(1) (2003).

264. 17 C.F.R. § 240.14d-100 (2003).

265. These disclosures also must be made in connection with third-party tender offers in accordance with Schedule TO. *Id.* The term “tender offer” is not defined in the 1934 Act or the related rules and regulations adopted by the SEC. See HAZEN, *supra* note 32, at 486-93 (noting the absence of a statutory and regulatory definition and describing the SEC’s current eight-factor test); Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767, 819 n.148 (2002) (“The Williams Act does not define the term ‘tender offer,’ leaving its definition to judicial determination.”); Hon. Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 605 (2002) (“Neither the Williams Act nor the SEC defines a ‘tender offer.’”); Michael D. Ebert, Comment: “*During the Tender Offer*” (or Some Other Time Near It): *Insider Transactions Under the All Holders/Best Price Rule*, 47 VILL. L. REV. 677, 678 (2002) (“Because neither Congress nor the SEC has clearly defined the term ‘tender offer,’ courts have been left to decide when and if a Rule 14d-10 violation has occurred in this non-classic situation.”); Rusty A. Fleming, *A Case of “When” Rather Than “What:” Tender Offers Under the Williams Act and the All Holders and Best Price Rules*, 27 S. ILL. U. L. J. 263, 263 (2003) (“Congress left the term ‘tender offer’ undefined in the Williams Act.”).

266. 17 C.F.R. § 229.1006(c)(1) (2003). It is particularly appropriate to reference disclosure rules regarding self-tenders in providing guidance on Example #2, since the directors of the Target in Example #2 purchased (rather than sold) the Target’s securities while in possession of nonpublic information. The reference would be similarly apt if Example #2 had related to a stock repurchase by the Target. Conversely, Example #1 relates to circumstances in which insiders sold securities of the issuer while in possession of undisclosed information.

267. 17 C.F.R. § 229.1005(b) (2003).

268. 17 C.F.R. § 240.14d-100 (2003).

company's securities; (5) [e]lection of the subject company's directors; or (6) [s]ale or other transfer of a material amount of assets of the subject company."<sup>269</sup> These disclosure requirements are consistent with, and (from the standpoint of financial impact and operational impact) arguably more inclusive than those envisioned by the *Basic* Court in adopting the "probability versus magnitude" test.<sup>270</sup>

With respect to informational currency, the key element of materiality is the passage of time.<sup>271</sup> Time defines both the existence and continuity of relationships (including insider status) in and under the federal securities laws and the connection between those relationships and the required disclosure of information in accordance with those laws. In fact, time-defined disclosure is an omnipresent element of mandatory (especially periodic) disclosure regulation, which calls for disclosure of various items, including financial information, as of a particular date or for, or during, a particular period of time.<sup>272</sup> In many cases, time is used as a means of limiting the volume of required disclosure.<sup>273</sup> As events become more distant in time, their importance to the reasonable investor may fade. Under the facts of Example #2, the informational currency element of materiality reflects the recognition (acknowledged *supra* Part II) that the status of a plan, proposal, or negotiation does not change overnight simply because the issuer or another party says so; a reasonable investor would be substantially likely to continue to find information about a plan, proposal, or negotiation important for a period of time after that plan, proposal, or negotiation is abandoned or terminated. In Example #2, then, assuming that Acquiror's offer is material under the *Basic* "probability versus magnitude" test<sup>274</sup> when received by Target, transaction planners and judges may wonder for

---

269. 17 C.F.R. § 229.1005(b) (2003). Note that these disclosures are not required for issuer tender offers.

270. See *Basic Inc. v. Levinson*, 485 U.S. 224, 238-39 (1988) (citing *SEC v. Geon Indus., Inc.*, 531 F.2d 39 (2d Cir. 1976) and setting forth basic criteria for evaluating the magnitude of preliminary merger discussions).

271. As noted below, when analyzing informational currency in Example #2, the analysis assumes that the premerger discussions between Acquiror and Target were material at the time they were occurring. The question then becomes when, if ever, those discussions cease being material.

272. See generally sources noted *infra* notes 275-85 and accompanying text.

273. *Id.*

274. In the exercise of prudence, a premium offer by the Acquiror for the Target would be treated by the Target as presumptively material, pending the Target's response, especially in the insider trading context. See *supra* notes 261 & 262 and accompanying text. Accordingly, controllable transactions triggering a duty to disclose on the part of the Target (e.g., an offering or stock repurchase program) would be delayed or held in abeyance until the course of conduct between the parties with respect to the offer is resolved (one way or the other).

how long the information about an offer for Target remains material after Target rejects the offer. In other words, when can Target and its insiders trade in the market without disclosing the offer?

As with the other areas of materiality, there are helpful guideposts with respect to informational currency in the law and the SEC's rules and regulations governing mandatory disclosure. Potentially relevant time periods under these rules and regulations range from three months to two years (as described below). Under the SEC's rules and regulations, from the perspective of substantive transactional disclosure regarding acquisitions, the two-year period is highly relevant.<sup>275</sup> As earlier noted, Item 1005(b) of Regulation M-A,<sup>276</sup> as incorporated into Item 5 of Schedule TO,<sup>277</sup> requires that a third-party tender offeror "describe any negotiations, transactions or material contacts during the past two years between the filing person [offeror] . . . and the subject company [target] or its affiliates . . ." regarding any one of a number of types of acquisition transaction.<sup>278</sup> Similarly, in connection with the disclosure of facts regarding the fairness of a "going private" transaction under Rule 13e-3 under the 1934 Act,<sup>279</sup> Instruction 2 of the instructions to Item 1014 of Regulation M-A<sup>280</sup> provides that

[t]he factors that are important in determining the fairness of a transaction to unaffiliated security holders and the weight, if any, that should be given to them in a particular context will vary. Normally such factors will include, among others, . . . whether the consideration offered to unaffiliated security holders constitutes fair value in relation to: . . . (viii) [f]irm offers of which the subject company or affiliate is aware made by any unaffiliated person, other than the filing persons, during the past two years for:

(A) [t]he merger or consolidation of the subject company with or into another company, or vice versa . . .<sup>281</sup>

Moreover, in two court opinions, both responding to motions for summary judgment, a two-year period after an acquisition offer had

---

275. Two-year informational currency also is prevalent in periodic financial disclosures required under Regulation S-X. *See, e.g.*, 17 C.F.R. § 210.3-01 (2003) ("There shall be filed, for the registrant and its subsidiaries consolidated, audited balance sheets as of the end of each of the two most recent fiscal years.").

276. 17 C.F.R. § 229.1005(b) (2003).

277. 17 C.F.R. § 240.14d-100 (2003).

278. 17 C.F.R. § 229.1005(b) (2003).

279. 17 C.F.R. § 240.13e-3 (2003).

280. 17 C.F.R. § 229.1014 (2003).

281. *Id.*

an important role. In each of *Caruso v. Metex Corp.*<sup>282</sup> and *Levinson v. Basic Inc.* (the *Basic* case, on remand to the U.S. Court of Appeals for the Sixth Circuit),<sup>283</sup> the court found that undisclosed information about acquisition offers more than two years old is not *per se* immaterial (in other words, could be material), as a matter of law.<sup>284</sup> Under the rule of these cases, information about a foregone acquisition proposal that is under two years old may or may not be material to an acquisition target.<sup>285</sup>

These disclosure measures and cases suggest a possible rule that provides for the presumptive immateriality, to an acquisition target, of information regarding an acquisition proposal made and withdrawn, rejected, or abandoned more than two years prior to the issuer or insider transaction triggering disclosure. Again, the presumption would be rebuttable based on a group of identified factors derived from current law and regulation, many of which can be drawn from cases.<sup>286</sup> But what of nonpublic acquisition proposal information that is two years old or less? Is an acquisition proposal *per se* or presumptively material? If so, until what point in time after it is withdrawn, rejected, or abandoned is it material? Can it be that the issuer and its insiders cannot trade in the market for two years after an undisclosed acquisition proposal without some level of security that information about the proposal is immaterial?

Interestingly, when an issuer provides disclosure in connection with an issuer tender offer, arguably the transaction most analogous to the director stock acquisitions in Example #2, the issuer is required to disclose in its Schedule TO<sup>287</sup> only one item related to acquisition proposals.<sup>288</sup> Pursuant to Item 6 of Schedule TO,<sup>289</sup> the issuer is

---

282. Fed. Sec. L. Rep. (CCH) ¶ 96,967, at 94,130 (E.D.N.Y. July 30, 1992). The *Caruso* court stated:

Defendants argue that even if the discussions regarding the acquisition of D&M were material in 1987, they were no longer material when the merger occurred in 1989. We find that the issue of whether the \$18.5 million buyout proposal constituted 'stale' information in 1989 is a factual question to be decided by the jury. The jury must determine whether an offer made in 1987 to acquire D&M for \$18.5 million 'would have assumed actual significance in the deliberations of the reasonable shareholder . . .' when deciding whether to approve the merger in 1989.

*Id.* (citing *Folger Adam Co. v. PMI Indus. Inc.*, 938 F.2d 1529, 1533 (2d Cir. 1991)).

283. 871 F.2d 562 (6th Cir. 1989).

284. See *infra* note 285; but see *Shahmoon v. Gen. Dev. Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 94,308, at 95,038 (S.D.N.Y. Dec. 1, 1973) (finding two-year-old information "obviously out of date" and, therefore, immaterial).

285. *Caruso*, Fed. Sec. L. Rep. (CCH) at 94,143; *Levinson*, 871 F.2d at 564.

286. The identification of factors is a creative process. SAB No. 99 again may be helpful here, even if not directly relevant. See *supra* note 250.

287. 17 C.F.R. § 240.14d-100 (2003).

288. The tender offer disclosure regulations under Regulation M-A, like the line-



required to describe under Item 1006(c) of Regulation M-A<sup>290</sup> any “plans, proposals, or negotiations that relate to or would result in: . . . [a]ny extraordinary transaction, such as a merger, reorganization or liquidation, involving the subject company or any of its subsidiaries; [or] . . . [a]ny purchase, sale or transfer of a material amount of assets of the subject company or any of its subsidiaries . . .”<sup>291</sup> The additional Regulation M-A disclosure items referred to above (as well as others not cited here) are not applicable to issuer disclosures in connection with issuer tender offers.<sup>292</sup> The absence of these required disclosures in the issuer tender offer context may indicate an SEC intention that only current, active acquisition plans, proposals, and negotiations are material *per se*, even in a context where the issuer is trading in its own securities. Perhaps, then, this mandatory disclosure requirement indicates guidance that presumes an acquisition proposal is material, subject to rebuttal based on a list of specified factors derived from current law and regulation,<sup>293</sup> for two years after it has been withdrawn, rejected, or abandoned.<sup>294</sup>

However, there are indications elsewhere in the federal securities regulations and related case law that, as noted above, a reasonable investor is substantially likely to continue to find information about an acquisition proposal important for a more limited period of time after that proposal is withdrawn, rejected, or abandoned.<sup>295</sup> Should a withdrawn, rejected, or abandoned offer remain *per se* material for a period of three months? Is a period of six months more prudent? Disclosure requirements relating to directors and executive officers in other contexts may give some guidance.<sup>296</sup>

---

item disclosure regulations under the 1933 Act and 1934 Act generally are qualified by the additional requirement that the disclosing party “[f]urnish such additional material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not materially misleading.” 17 C.F.R. § 229.1011(b) (2003).

289. 17 C.F.R. § 2240.14d-100 (2003).

290. 17 C.F.R. § 229.1006(c) (2003).

291. *Id.*

292. See HAZEN, *supra* note 32, at 517-18 (describing filing and disclosure requirements applicable to issuer tender offers).

293. Here, factors may include whether the acquisition proposal had been formally withdrawn by the putative Acquiror, as opposed to it having been rejected by the target or abandoned. Other factors may be obtained from existing decisional law.

294. In the interest of completeness, the guidance also should address the question of when a proposal is deemed withdrawn, rejected, or abandoned.

295. See *infra* notes 297-308 and accompanying text.

296. For purposes of this part of the informational currency analysis, directors and executive officers of a corporation are presumed “insiders” of the corporation. A review of the reach of basic reporting requirements for these insiders—especially the extent to which they continue for a period of time after the director or officer ceases

A possible, albeit weak, justification for a three-month *per se* materiality period derives from Rule 144 under the 1933 Act.<sup>297</sup> The three-month period regarding affiliate status under Rule 144(k)<sup>298</sup> is intended to ensure, by the passage of time, that a seller of securities under the rule that once was an affiliate of the issuer has no remaining control relationship with the issuer at the time a sale of issuer securities is made by the former affiliate.<sup>299</sup> The rule assumes that control no longer exists after three months and, accordingly, terminates the affiliate's disclosure obligations under the rule (as applicable to sales of unrestricted securities and restricted securities held for two years or more at the conclusion of that period).<sup>300</sup>

A possible justification for a six-month *per se* materiality period derives from Section 16(b) of the 1934 Act ("Section 16(b)")<sup>301</sup> and the duration of the related reporting obligations provided for under Section 16(a) of the 1934 Act.<sup>302</sup> Under Section 16(b), directors, officers, and ten percent beneficial owners of publicly traded stock<sup>303</sup> of an issuer are held responsible to the issuer for deemed profits from a purchase and sale, or sale and purchase, of the issuer's securities within a six-month period.<sup>304</sup> The liability for these deemed "short-swing profits" is strict and prophylactic. The express purpose of the provision is to prevent "the unfair use of information which [sic] may have been obtained . . . by reason of . . . [the subject person's] relationship to the issuer."<sup>305</sup>

---

to be engaged in a corporate capacity—may be deemed to provide additional guidance on informational currency. *See infra* note 297 (regarding a requirement of this kind in Rule 144(k) under the 1933 Act).

297. *See* 17 C.F.R. § 230.144 (2003). Paragraph (h) of Rule 144 provides, among other things, for affiliates of an issuer, including its directors, to publicly disclose their intention to sell the issuer's securities before sales are made. *Id.* Paragraph (k) of Rule 144 effectively provides that those who, at the time of the sale and for three months prior to the sale, are not affiliates of the issuer's need not give advance public warning of their proposed sales of securities other than restricted securities held for less than two years. *Id.*

298. *See id.*

299. *Id.*

300. *Id.* Although the three-month rule in Rule 144(k) relates to a change in status of the insider trader and not a change in the status of the information possessed by that insider, it remains instructive here, if for no other reason than that previously required disclosures no longer are required based merely on the passage of time.

301. 15 U.S.C. § 78p(b) (2003).

302. 15 U.S.C. § 78p(a) (2003).

303. For these purposes, publicly traded stock is stock that is registered under Section 12 of the 1934 Act.

304. 15 U.S.C. § 78p(b) (2003).

305. *Id.*; *see* HAZEN, *supra* note 32, at 710 ("The legislative history reveals congressional recognition of such a great potential for abuse of inside information so as to warrant the imposition of strict liability.").

Supportive of the six-month strict liability provisions in Section 16(b) are the filing requirements of Section 16(a) of the 1934 Act.<sup>306</sup> Under Section 16(a), directors, officers, and ten percent beneficial owners of publicly traded stock of an issuer must file initial and periodic reports of beneficial ownership of the issuer's securities on Forms 3 and 4, respectively, and also may be required to file an annual report of beneficial ownership on Form 5.<sup>307</sup> A director or officer of the issuer is required to report nonexempt transactions in the issuer's securities that occur after he or she ceases being a director or officer of the issuer if those transactions are "[e]xecuted within a period of less than six months of an opposite transaction subject to Section 16(b) of the Act that occurred while that person was a director or officer."<sup>308</sup> Based on the foregoing, it may then be sufficient to adapt disclosure guidelines that label an acquisition proposal as (a) *per se* material during the time it is actively being considered and for three months or six months after it is withdrawn, rejected, or abandoned, (b) presumed material after that three-month or six-month period until two years have passed since the withdrawal, rejection, or abandonment of the proposal (which presumption is rebuttable by the issuer or insider based on a list of specified factors derived from current law and regulation), and (c) presumed immaterial after two years have passed since the withdrawal, rejection, or abandonment of the proposal (which presumption is rebuttable by an investor plaintiff, or prosecutor based on a list of specified factors derived from current law and regulations).

#### CONCLUSION

The single uniform legal standard governing materiality, while well settled, often lacks clarity when applied. Transaction planners, litigants, the SEC and its staff, representatives of the DOJ, and judges—each of whom is charged with using this ambiguous standard in critical decision-making—would benefit from additional guidance in making materiality determinations, especially in the insider trading context. The ambiguities inherent in interpreting and applying the existing materiality standard are not essential to the promotion of policy objectives underlying U.S. insider trading regulation.

---

306. 15 U.S.C. § 78p(a) (2003).

307. See 17 C.F.R. § 240.16a-3 (2003).

308. 17 C.F.R. § 240.16a-2 (2003). The note to paragraph (b) explains that "an acquisition and a disposition each shall be an opposite transaction with respect to the other." *Id.*

Moreover, the vagueness in the existing materiality standard negatively impacts stockholder value in a manner that may undercut those policy objectives (including by the encouragement of expensive and time-consuming securities class action litigation that is likely to settle for substantial dollar amounts, regardless of merit).

Fair and honest securities markets, investor confidence in those markets, and accurate and complete public disclosure in the insider trading regulation context all can be enhanced by the adoption of more precise materiality guidance for use in insider trading analysis. This guidance for determining materiality can be fashioned by creating a meaningful overarching process for determining materiality, consistent with existing law, and rigorously applying that process to common factual settings in various areas of materiality analysis. If properly crafted, the materiality guidance resulting from this process would support applicable policy and enhance predictability and certainty in the *ex ante* and *ex post* application of Rule 10b-5 in the insider trading context. Given the desirability of fostering market integrity and confidence in the current securities trading environment, Congress, the SEC, or the courts should take action to provide enhanced materiality guidance for use by issuers and insiders as part of a more comprehensive post-Enron agenda.