Public Chatter

The Challenges of the “Materiality” Determination

By Broc Romanek | Strategist

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The Challenges of the "Materiality" Determination

- ***by Broc Romanek***

This Guidebook about "The Challenges of the "Materiality" Determination" is meant to be practical. I'm hoping its quasi-conversational nature helps you more easily consume the lessons imparted. Enjoy – and please share your own practice tips or your own anecdotes, for the next edition of this Guidebook!

1. THE LONELINESS OF MAKING THE MATERIALITY DECISION

You're sitting in your office staring at your fern when it dawns on you. It's all you, dude. The buck stops here.

You remember the law school lessons. *TSC Industries v. Northway* in 1976. That case has its own Wikipedia page, for heaven's sake. "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important." And then there's *Basic v. Levinson* in 1988 that reiterated the *TSC Industries* standard: "A substantial likelihood that the information would have been viewed by a reasonable investor as having significantly altered the total mix of information made available."

I served in-house at a Fortune 40 company before the enlightened era of disclosure committees, so I was surprised to hear from my in-house friends that not much has changed. It's still a lonely endeavor. The job of making the materiality call typically lands in the lap of the in-house securities lawyer. Not the GC. You.

Or, even worse, you made the call to *include* the disclosure but you've been overruled by the CFO or the controller – perhaps even the CEO - and now you've got to write up that memo to the file explaining why you've omitted the thing. Your heart isn't in it. You don't agree. There's that gnawing feeling in your stomach.

The disclosure committee might convene for a Form 8-K determination – but it won't gather for a ruling related to the Form 10-K or 10-Q. Not that it matters. Even in those instances when the disclosure committee convenes, the committee members often look to you as the securities lawyer to make the judgment call.

You can't rely on your law firm to make the call. Smart firms won't touch it with a 10-foot pole. They don't know all the facts. They're not in the best position to assess. True, they might share anecdotes of what clients did in similar situations, they may give you some counsel - but they're not going to make the call.

To best protect yourself, the key is to document the disclosures you don't make. Don't worry as much about the ones you do make, unless you have a reason to be worried about the accuracy of the disclosure. Misleading disclosure is easier to spot by a plaintiff's lawyer than omitted disclosure. This memo that you draft – sometimes called a "SAB 99" memo, based on the SEC accounting guidance in that Staff Accounting Bulletin – is all part of your disclosure controls.

For those "omission" calls, there just aren't any data analytics to pull from, to compare with. These are instances of what companies *didn't* do. It's not publicly known. Your own determinations aren't even well-known within your own company.

As the band "America" sings:

This is for all the lonely people
Thinkin' that life has passed them by
Don't give up until you drink from the silver cup
And ride that highway in the sky

2. THE HARD TRUTH ABOUT DISCLOSURE COMMITTEES

Yes, my titles tend to be a tad dramatic. That's the way to draw eyeballs, right? But in this case, it is a hard truth. Disclosure committees are not much of a committee at most companies.

The notion of a "disclosure committee" was born in 2002, when the SEC's adopting release relating to disclosure controls recommended that companies form disclosure committees. It wasn't required that companies do so – just recommended. Surveys show that most companies do indeed have one.

That adopting release indicated that committee could include the principal accounting officer (or the controller), the general counsel or other senior legal official with responsibility for disclosure matters, the risk management officer, the chief investor relations officer, and others deemed appropriate, including business unit people.

The disclosure committee essentially has three tasks: draft and review disclosure for the company's SEC filings, keep an eye out for things that happen at the company that should be disclosed – and help make those challenging "materiality" judgements for those situations that bubble up to the committee.

The reality is that it's rare to have someone within a company truly interested in bubbling up information to those on the disclosure committee, even if they're specifically tasked to do so. After all, who wants to raise their hand to take on extra work?

The upshot is that at most companies, the lawyer primarily responsible for drafting and those in Finance involved with the numbers are the gatekeepers of what goes into the SEC filings. Others typically play nominal roles – sticking to their lanes - such as the tax person being responsible for tackling the tax section of the Form 10-K.

The gatekeepers strive to ensure that what goes into the SEC filings is consistent – they try to keep the disclosure from becoming disjointed. They're wearing "quality control" hats. Everyone else? They barely care. The drafting task isn't much of a group effort.

Let's face it. No one's clamoring to wear an "I'm on the disclosure committee" T-shirt.

3. THE HARD TRUTH ABOUT DISCLOSURE COMMITTEES

Your company has a pretty good risk management department. They're good at bubbling up all sorts of issues to consider. They're providing you with detailed analysis behind each of the risks.

But they're not SEC lawyers. That's you. Little – and lonely – you. No one is going to tell you what rises to the level of "let's throw this into the 10-K for the first time."

Okay, it's you. So where do you start? It's about looking at the "total mix of information." That makes sense. You're looking at all the information available to you.

You consider what the company has publicly disclosed in the past. Not just in SEC filings, but in investor presentations, press releases and so forth. You need to have a good handle on everything posted on your corporate website, as well as other content that’s being handed out not captured there.

You’re looking at the new information against that backdrop, asking yourself what it looks like: a significant departure? A new trend? How does it all fit together?

Step back for a moment and consider, “How is it going to be perceived?” That’s something to ponder. If your stock price suddenly lurches, that’s a signal in hindsight that some considered that information material. Did that information come from outside the company? Or from someone within? If within, maybe it belongs within your SEC filing stream.

Obviously, you draw upon your own experiences, your own beliefs. The views of those you ask – both those within the company and outside.

But there’s no magic here. No real data analysis, just looking to see what other companies are disclosing. Responding to what investors and analysts are looking for. How the stock moved in response to something similar in the past. Responding to incidents that make the news. It’s a gut instinct kind of thing.

Maybe one day there will be artificial intelligence to help you. But for now, it’s a human-driven process.

4. HOW “MATERIALITY” WILL RUIN YOUR LIFE

“Ms. In-House Lawyer, can you tell me whether this is material?” If I hear that one more time (*shakes fist*).

Determining whether something is “material” seems to dominate every question in every form. It shows up in a wide range of questions that you’ll receive from your work colleagues when you’re in-house, ranging from insider trading to disclosure in SEC filings.

It even extends to interactions with other parties. For example, is this contract with this other company “material” and does it need to be disclosed? Include dealings with customers, vendors, and suppliers on your list. The list is endless.

Unfortunately, there is no neat answer. It’s elusive. It’s a facts and circumstances determination.

The definition of materiality depends on the context. For example, it’s a lower “reasonably likely to occur” threshold for MD&A (the disclosure in your SEC filings about known trends and uncertainties& certainties) compared to the “probability/magnitude” materiality test of *Basic v. Levinson* and other caselaw for other disclosures. Then the SEC has materiality guidance in the Rule 10b5-1 plan area.

On the whole, “materiality” is challenging to grasp because there are no bright line tests. It can be maddening.

Your co-workers aren’t happy when you tell them that the answer is that there’s essentially no answer. They want a checklist. Yet, they constantly ask you over and over again whether something is material.

They never learn, and they can’t grasp, that the answer is “I’m not sure.”

5. HOW DO THE ACCOUNTANTS FIT INTO “MATERIALITY” DECISION-MAKING?

I’ve noted that documenting your decision is key. That the memo documenting the decision is sometimes called a “SAB 99” memo, based on the SEC accounting guidance in that Staff Accounting Bulletin. Think disclosure controls.

So that begs the question? If a piece of SEC Staff accounting guidance is implicated, does that mean the accountants play a big role in the materiality decision?

Well, the CFO and the controller normally weigh in, either for a Form 8-K as part of their membership on the disclosure committee – or as part of the normal drafting process for the 10-Qs and 10-Ks. But like the other members of the disclosure committee, they typically defer to the in-house securities lawyer to make the final judgment call.

And in most cases, the independent auditor won’t weigh in unless it’s discussed as part of the normal vetting process for the 10-Qs and 10-Ks. Some companies have their independent auditors sit in on their disclosure committee meetings. If the materiality issue is vetted during one of those meeting, the auditors have a chance to weigh in. But most 8-K issues are quickly decided upon without a disclosure committee meeting – so the auditor isn’t asked.

When the decision to not disclose is reported out later at a regular disclosure committee meeting, then the auditor can question why an 8-K wasn’t filed. At that point, they would be evaluating the materiality issue as part of their internal control assessment – and perhaps in extreme cases, whether the failure to disclose constitutes a “material weakness.”

So it’s a bit odd that the auditor isn’t initially consulted – but then is offered the opportunity to second-guess your decision and hit that big red button that blares out “material weakness.” That’s a huge consequence that can rock your company’s stock price.

Of course, the odds are that if consulted, your auditor wouldn’t have much to say (akin to your law firm’s reluctance to get too involved). Auditors aren’t close to all the facts. Why take the unnecessary risk?

I’ve checked with my experienced in-house counsel friends and they can recall only a few instances where the auditor was consulted on a materiality issue. You can bet your bottom dollar that the auditors were hesitant to make the actual determination every time. As could be expected, they were more focused on the controls process than on the materiality decision itself.

6. HOW DO YOU DETERMINE THE “MATERIALITY” OF AN ESG ISSUE?

We can all agree that “materiality” decisions can be tough. The determinations tend to be highly subjective on the margins. In the gray areas.

And that’s just when you’re trying to put yourself in the shoes of a “reasonable investor.” What happens when it comes down to ESG and you’re trying to apply a “double materiality” threshold?!? Whoa, Nelly!

A brief primer on “double materiality.” “Single materiality” is inwardly focused: “how does this impact the company?” In comparison, “double materiality” is both inwardly and outwardly focused: “how does this impact the company? as well as how does this impact our stakeholders?” That’s the distinction at a glance.

Sweat starts to form on the brow.

Very few companies are applying a form of double materiality. The Shareholder Commons announced last year that it had withdrawn a shareholder proposal at Yum! because the company agreed to disclose the systemic effects of the use of antibiotics in its supply chain by the end of this year. The press release notes that Yum! will be first public company in the United States to disclose its impacts on the global economy and the interests of diversified shareholders.

So what happens in practice for those companies still operating with "single materiality" as their mandate? In their SEC filings, companies are mostly reactive when it comes to what they're choosing to disclose about their E&S issues.

Through shareholder engagement – or by complying with the policies of their major investors and the proxy advisors – they have signposts of where they need to be to keep those stakeholders happy. (By the way, I say all this putting aside the potential environmental liability disclosures you may be required to make in your "Legal Proceedings" section. [The ones triggered by Item 103 of Regulation S-K.])

Aside from pressure from investors and other stakeholders—who might even include employees these days, who actually are your shareholders, too, in many cases – an ESG issue is not likely to have a big impact on your numbers or rise to the level of a material "trend" for discussion in the MD&A, particularly considering that the timeframe for trend disclosure is near-term.

The reality is that E&S isn't otherwise likely to come up as part of the quarterly process unless related issues are proactively raised. It's not likely to be teed up unless it comes up as part of the general discussion of risk factors. But it's now likely to come up because ESG is first and foremost on almost everyone's mind—and so, E&S likely will be raised.

I should also mention there are also concepts of "nested" and "dynamic" materiality in the various ESG standards. "Nested materiality" essentially is a hybrid of the single and double materiality standards. "Dynamic materiality" is materiality that may be changeable or fluid over time. Isn't that a little confusing? See this article entitled "Materiality Across Asset Classes: A Look At Fixed Income ESG Integration."

And former SEC Commissioner Allison Herren Lee delivered this speech on materiality in the ESG context to dispel four common myths. Her four myths were:

- Myth #1: ESG matters (indeed all matters) material to investors are already required to be disclosed under the securities laws.
- Myth #2: Where there is a duty to disclose climate and ESG matters, we can rest assured that such disclosures are being made.
- Myth #3: SEC disclosure requirements must be strictly limited to material information.
- Myth #4: Climate and ESG are matters of social or "political" concern, and not material to investment or voting decisions.