The attached article, Corporate Governance Update: "Materiality" in America and Abroad, was published in the New York Law Journal on April 29, 2021

April 29, 2021

Corporate Governance Update: "Materiality" in America and Abroad

David A. Katz
and
Laura A. McIntosh*

The concept of materiality is a bedrock feature of American securities law and regulation. It informs the way investors think, talk, and transact, the way lawyers advise their clients, and the way legislators and regulators draft and enforce federal mandates. The working definition of materiality in the United States, which has served corporate America well for nearly nine decades, now finds itself facing significant pressures from a variety of sources. The European Union, the World Economic Forum, and other stakeholder- and EESG-oriented organizations are advocating for a broader definition and developing concepts of expanded materiality that go far beyond the traditional American approach in ways that threaten to undermine the usefulness of materiality as a guiding principle for disclosure.

In the current debate over materiality, two issues should remain distinct: the importance of stakeholder governance and EESG on the one hand, and the question of redefining the standard of materiality from a securities law and market perspective on the other. Institutional investors in the United States are increasingly focused on stakeholder governance and EESG issues, and corporate disclosure on these topics can and should be addressed within the American framework of materiality. If disclosure of immaterial information is required for non-financial reasons, it should be acknowledged as such and not swept into the concept of materiality. There are examples of such requirements under U.S. law, but though these disclosures are mandated, the information provided is not considered "material." In an article forthcoming in May, we will address the issues that would arise in connection with SEC-mandated EESG disclosures.

The SEC and the Supreme Court, in formulating the American definition of materiality in the securities law context, borrowed the "reasonable person" standard from tort law to create a concept that has stood the twin tests of time and an ever-changing world. The definition is fixed, yet adaptable to dynamic circumstances. To the extent that the emerging formulations from across the Atlantic explicitly incorporate a current perspective on stakeholder and environmental impacts, for example, the U.S. formulation accomplishes the same goal through the "reasonable investor" test, which is applied in the context of its time. It would be both unnecessary and misguided to revise the traditional American definition of materiality, whether explicitly or indirectly, to attempt to mirror the contemporary European approach.

---

* David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz. Laura A. McIntosh is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.

The American Definition of Materiality

The word "material" was first introduced in the U.S. Securities Act of 1933, and, at least since the 1940s, the SEC has defined "material information" in the context of financial statements as "those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." That language was amended slightly in 1982 with the adoption of the modern version of Rule 405 of the Securities Act, but the SEC has hewed closely to the substance of the definition over the decades, stating in 1999 that "[a] matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important."

The landmark judicial definition of the term was crafted by Justice Thurgood Marshall of the Supreme Court in 1976, when he wrote in *TSC Industries* v. *Northway* that a fact is "material" if there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," or "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." In 1988, the Supreme Court expressly adopted this definition for the Rule 10b-5 securities fraud context in *Basic* v. *Levinson*. Notably, the Supreme Court observed in *Basic*, which involved a merger transaction, that "with respect to contingent or speculative information or events," materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event."

This longstanding American understanding of materiality is under pressure today from a variety of sources, and not for the first time. In 1978, then-SEC Commissioner Roberta Karmel spoke presciently of issues that have grown all the more pressing in the last half-century:

> "As greater numbers of Americans become owners of our large public corporations, whether individually or through institutional investors, and as corporations become subject to increasing government regulation, the dialogue between shareholders and their corporations becomes part of a larger political process. Nevertheless, and despite the legitimate concerns of ethical investors, I believe we should exercise caution in applying a non-economic standard of materiality to disclosure requirements…. Because some investors may want certain information in order to make an investment or voting decision does not mean that mandatory disclosure of such information would be necessary or appropriate in the public interest or for the protection of investors."

Former Commissioner Karmel's observations are as clear-eyed and trenchant now as they were in the 1970s. Today, the pressures to expand the American concept of materiality are sweeping, systemic, and stronger than ever.

Emerging European Concepts of Materiality

Although the U.S. Securities and Exchange Commission is currently considering EESG disclosure requirements, the European Union is the global leader in efforts to develop climate change and other EESG disclosure metrics. Its approach includes revising the working definition of materiality in the EU to include the concepts of "double materiality" and "dynamic materiality." "Double materiality," introduced in 2019, is the idea that materiality has two substantive prongs, the first being financial materiality and the second being environmental and social materiality; information and issues can be deemed material from either of these two perspectives. Therefore, "companies should disclose not only how sustainability issues may affect the company, but also how the company affects society and the environment." The philosophy behind double materiality, which underpins the EU's Non-Financial Reporting Directive, is that "[t]hese two risk perspectives already overlap in some cases and are increasingly likely to do so in the future."

The concept of "dynamic materiality" was described by the World Economic Forum in a 2020 white paper: "One area in which investors have begun initial explorations is anticipating how issues might become financially material either across an entire industry, or for a specific company. What is financially immaterial to a company or industry today can become material tomorrow, a process called 'dynamic materiality.'" The WEF released a second 2020 white paper recommending metrics-based EESG disclosures employing this concept, stating: "Our perspective is that the recommended metrics reflect not only financial impacts but 'pre-financial' information that may not be strictly material in the short term, but are material to society and planet and therefore may become material to financial performance over the medium or longer term. Materiality is a dynamic concept, in which issues once considered relevant only to social value can rapidly become financially material."

The Global Reporting Initiative (GRI), a prominent Netherlands-based proponent of standards for sustainability reporting, is in the process of revising its definition of materiality to include double materiality. In its 2020 exposure draft for comment on the proposed revisions, GRI took the position that material topics are those "that reflect the organization's most significant impacts on the economy, environment, and people, including impacts on human rights," on the theory that understanding those impacts "is necessary in order to identify financially material risks, opportunities, and impacts." GRI is not alone in following the lead of Europe and the WEF; the whole "Group of Five," which includes four other reporting standards organizations in addition to GRI — CDP, the Climate Disclosure Standards Board, the International Integrated Reporting Council (IIRC), and the Sustainability Accounting Standards Board (SASB) — released two papers in 2020 embracing the concept of dynamic materiality.

These European concepts already appear to be gaining traction in the United States. SASB, the only member of the Group of Five that is U.S.-based, is also in the process of revising its conceptual framework, including its definition of materiality. The proposed change adds the element of time horizons: "[I]nformation is financially material if omitting, misstating, or obscuring it could reasonably be expected to influence investment or lending decisions that users make on the basis of their assessments of short-, medium-, and long-term financial performance and enterprise value." This formulation, albeit phrased in terms of financial materiality, was revised by SASB explicitly "to more effectively communicate the global nature of the concept of financial materiality… [and] to align as much as reasonably possible with the definitions of 'materiality' used by the standard setters and other organizations who, like SASB, have a focus on the information needs of providers of capital, e.g., … the International Integrated Reporting Council." In other words, the incorporation of time horizons represents a deliberate step toward the concept of dynamic materiality, which, per the WEF, is viewed in Europe as a far more "forward-looking and proactive" approach than the traditional U.S. definition.

Disclosure Should Be Decision-Useful to Investors

The objective of mandatory material disclosure is to provide decision-useful information to the reasonable investor at a specific point in time. The central weakness of the European formulations of double materiality and dynamic materiality is that, once the universe of disclosure is expanded beyond financially material information, there is no clear limiting principle. Any investor may believe that specific non-financial issues are "material" to their investment decisions, yet these issues may not be relevant more broadly to other investors. There are other ways for investors who seek non-financial company information to obtain it, including analyst reports, company news releases, and direct engagement. Limiting the universe of mandatory disclosure to financially material information ensures that disclosures have broad applicability and clear utility to the average prudent investor. As Former Commissioner Karmel observed nearly a half-century ago, requiring disclosure of information that some investors — but not "average, prudent" investors — might deem important to their investment decisions would not be in the best interests of investors or the public interest. To the extent non-financial information disclosure is mandated for other reasons (such as ethical or environmental), a clear distinction should be made between the specific disclosure requirements themselves and what is "material" to investors. The Dodd-Frank Wall Street Reform and Consumer Protection Act took this approach, requiring public company disclosure of financially immaterial information including issuers' use of conflict minerals, issuers' payments to national governments for resource extraction, and the CEO pay ratio. Requiring the disclosure of immaterial information can be costly and of little use to investors, but it would be far worse if the information required were deemed "material" for securities law and enforcement purposes.

The genius of the "reasonable investor" definition of materiality is that the formulation already accomplishes the worthwhile aspects of the new concepts of double and dynamic materiality. If a reasonable investor today would consider the information encompassed in double materiality to be important to an investment decision, then it is, by definition, included. Justice Marshall saw clearly the dangers of over-inclusive disclosure, stating in *TSC* v. *Northway*: "Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." Where materiality is over-inclusive, he observed, "not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decision-making." SEC Commissioner Hester Peirce has pointed out that "[t]he European concept of 'double materiality' has no analogue in our regulatory scheme." The U.S. regulatory scheme would be weakened, not improved, by redefining materiality to explicitly include elements that are not already covered by the reasonable investor standard.

As to dynamic materiality, the Supreme Court in *Basic* v. *Levinson* explicitly addressed the importance of balancing probability and magnitude when evaluating distant or uncertain events: "Where … the event is contingent or speculative in nature, it is difficult to ascertain whether the 'reasonable investor' would have considered the omitted information significant at the time." The Supreme Court was correct in its judgment that contingent or speculative events should not be accorded the same treatment as nearer-term, more predictable ones. If the concept of dynamic materiality gains steam, it would not be a stretch for it to include speculation as to matters other than environmental impacts, such as social and political issues, and very quickly the universe of possible outcomes would grow too large to provide a meaningful basis for disclosure. Uncertainty and conjecture are antithetical to decision-useful disclosure for investors. There is no small irony in the fact that — in a most simplified version of the story — the stakeholder-governance movement arose from concerns that investors were harmed by short-term decision-making that was detrimental to long-term prosperity, and yet now the excessive long-termism of the dynamic materiality concept threatens to harm investors by undermining the utility of corporate disclosures.

It is worth noting that the American concept of materiality is already "dynamic" insofar, as the Business Roundtable correctly stated in 2015, as it "naturally evolves over time to address new issues and developments and takes into account the facts and circumstances that are relevant to each company." Over the years, material issues have encompassed unprecedented developments including, for example, Y2K, cybersecurity risk, global terrorism, and the COVID-19 pandemic. To the extent an issue becomes material — to a reasonable investor at that moment in time — it is already required to be disclosed. If it is not material, its disclosure is at best a distraction for investors and issuers and at worst a time-consuming, expensive, legally perilous activity that is potentially detrimental to shareholders, the markets, and the economy as a whole. Though there are indications that most major institutional investors still prefer to maintain the traditional definition, there is growing interest in the new European formulations, and the SEC will face increasing pressure to take some form of action in this direction.

In 1977, a Congressional committee wrote in a report to the SEC that "[t]he concept of materiality is the cornerstone of the disclosure system established by the federal securities laws." That statement remains true. Over the last century, the American definition of materiality has been a great gift to shareholders and issuers. It paved the way for a disclosure regime of real use and value to the financial market. It is to be hoped that U.S. regulators, lawmakers, and investors recognize that this cornerstone remains an essential piece of the foundation of corporate America, and refrain from chipping away at its substance.