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Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading

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Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading

Joan MacLeod Heminway*

*Issuers, investors, and regulators have struggled with applying the materiality test since the enactment of the securities laws.*¹

I. INTRODUCTION

Insider trading has been in the news on a relatively constant basis in the new millennium. Raj Rajaratnam and associates,² Mark Cuban,³ and Martha Stewart⁴ have been among the many subjects of legal actions involving insider trading since the Enron debacle in 2002. Some of these cases have been garden-variety insider trading cases; others have exposed confusing and evolving elements of U.S. insider trading doctrine.⁵ Most recently,

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1. Paul S. Atkins, Commissioner, *Remarks to the 'SEC Speaks in 2008' Program of the Practising Law Institute*, U.S. SEC. & EXCH. COMM'N (Feb. 8, 2008), <http://www.sec.gov/news/speech/2008/spch020808psa.htm>.

2. See Press Release, *SEC Charges Billionaire Hedge Fund Manager Raj Rajaratnam with Insider Trading*, U.S. SEC. & EXCH. COMM'N (Oct. 16, 2009), <http://www.sec.gov/news/press/2009/2009-221.htm>; see also Press Release, *SEC Obtains Record \$92.8 Million Penalty Against Raj Rajaratnam*, U.S. SEC. & EXCH. COMM'N (Nov. 8, 2011), <http://sec.gov/news/press/2011/2011-233.htm>.

3. See Press Release, *SEC Files Insider Trading Charges Against Mark Cuban*, U.S. SEC. & EXCH. COMM'N (Nov. 17, 2008), <http://www.sec.gov/news/press/2008/2008-273.htm>.

4. See Press Release, *SEC Charges Martha Stewart, Broker Peter Bacanovic with Illegal Insider Trading*, U.S. SEC. & EXCH. COMM'N (June 4, 2003), <http://www.sec.gov/news/press/2003-69.htm>; see also Press Release, *SEC Charges Martha Stewart, Broker Peter Bacanovic with Illegal Insider Trading*, U.S. SEC. & EXCH. COMM'N (Aug. 7, 2006), <http://www.sec.gov/news/press/2006/2006-134.htm>.

5. See generally, e.g., *MARTHA STEWART'S LEGAL TROUBLES* (Joan MacLeod Heminway ed., 2007) (exploring, especially in chapters 1, 5, and 10,

congressional hearings on the STOCK Act⁶—a bill providing for an express congressional prohibition on insider trading—have made headlines.⁷ Public reporting in connection with both recent legal actions and the introduction and passage of the STOCK Act also has brought to the fore long-debated questions about insider trading doctrine in the United States, including the unsettled nature of the system of regulation.⁸ This article urges the U.S. Securities and Exchange Commission (“SEC”)—or, absent action by the SEC, the federal judiciary—to adopt clarifying guidance on materiality—one unclear area of insider trading law.

various uncertainties in insider trading policy and doctrine exposed in connection with the SEC insider trading enforcement action brought against Martha Stewart); Joan MacLeod Heminway, *Martha Stewart and the Forbidden Fruit: A New Story of Eve*, 2009 MICH. ST. L. REV. 1017 (using the *Stewart* case to identify unclear aspects of U.S. insider trading law); Anthony Michael Sabino & Michael A. Sabino, *From Chiarella to Cuban: The Continuing Evolution of the Law of Insider Trading*, 16 FORDHAM J. CORP. & FIN. L. 673 (2011) (describing the uncertain state of the requisite breach of a duty of trust and confidence after the trial and appellate court opinions in the *Cuban* case).

6. See Stop Trading on Congressional Knowledge Act, S. 2038, 112th Cong. (2012), available at <http://www.gpo.gov/fdsys/pkg/BILLS-112s2038eah/pdf/BILLS-112s2038eah.pdf> (House amendment of Senate bill, adopted on February 9, 2012).

7. See Paul Kane, *Ethics reform bill to ban insider trading by Congress members, executive branch passed by House*, WASH. POST, Feb. 9, 2012, available at http://www.washingtonpost.com/politics/ethics-reform-bill-to-ban-insider-trading-by-congress-members-executive-branch-passed-by-house/2012/02/09/gIQAV3MS1Q_story.html; Robert Pear, *House Passes Bill Banning Insider Trading by Members of Congress*, N.Y. TIMES, Feb. 9, 2012, available at <http://www.nytimes.com/2012/02/10/us/politics/house-passes-bill-banning-insider-trading-by-members-of-congress.html>.

8. See, e.g., Matthew Goldstein, *Steve Cohen says insider trading rules are “vague.”* REUTERS, Dec. 13, 2011, <http://www.reuters.com/article/2011/12/13/us-sac-cohen-deposition-idUSTRE7BC1UJ20111213>; David N. Lawrence et al., *Insider Trading 2011: How Technology and Social Networks Have ‘Friendened’ Access to Confidential Information*, KNOWLEDGE@WHARTON, May 11, 2011, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2776> (noting that “the precise conduct under the definition of insider trading has always been vague”); Jonathan Macey, *Congress’s Phony Insider-Trading Reform*, WALL ST. J., Dec. 13, 2011, available at http://online.wsj.com/article/SB10001424052970203413304577088881987346976.html?mod=WSJ_Opinion_LEADTop (describing current insider trading rules as “broad and vague”) [hereinafter *Phony Insider-Trading*]; Jonathan Macey, *Deconstructing the Galleon Insider Trading Case*, WALL ST. J., Apr. 19, 2011, available at <http://online.wsj.com/article/SB10001424052748704529204576256754289698630.html> (observing that “[f]or decades, the SEC has kept the insider-trading rules vague and undefined.”) [hereinafter *Deconstructing*]; Frank C. Razzano, *Insider Trading: Ambiguous Statute as Warning*, BLOOMBERG L. REP., June 20, 2011, available at http://www.pepperlaw.com/publications_article.aspx?ArticleKey=2140.

Adoption of this materiality guidance would affect the discretion of enforcement agents in (and judicial review of) insider trading actions. Accordingly, the remainder of this introduction lays a foundation for the proposed guidance by describing the enforcement discretion, judicial deference, and doctrinal contexts in which the guidance would operate, before establishing a few premises from this author's earlier work in which that guidance is grounded. The article then proceeds (before briefly concluding) to propose the desired materiality guidance, identify the SEC as the most appropriate rulemaking body to adopt the guidance, and suggest a specific form in which the guidance should be issued.

A. A Matter of Enforcement Discretion

The SEC, historically a primary enforcement agent in insider trading actions, has asserted a strong role in shaping the unsettled components of insider trading law in the United States. Because the SEC has enforcement authority and because various aspects of U.S. insider trading law are susceptible of multiple interpretations, the SEC can (and does) assess the facts and circumstances of individual transactions and, after the fact, call some of those transactions into question by pursuing enforcement activities that explore and settle open doctrinal questions.⁹ The SEC is not alone among enforcement agents in exercising enforcement discretion in this manner.¹⁰ In arguing for more clarity in U.S. insider trading

9. See, e.g., *Dirks v. SEC*, 463 U.S. 646 (1983) (in which the SEC unsuccessfully enforced Section 10(b) and Rule 10b-5 against a broker-dealer who traded on material nonpublic information, establishing the elements of tipper-tippee insider trading liability); *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated and remanded*, 620 F.3d 551 (5th Cir. Tex. 2010) (in which the SEC sought validation of a novel interpretation of the duty of trust and confidence necessary for insider trading liability); see also Lawrence et al., *supra* note 8 (indicating that the SEC preserves enforcement discretion in the insider trading context so that it may pick and choose those it may prosecute); Macey, *Deconstructing*, *supra* note 8 (noting that ambiguity in insider trading rules “increases the SEC’s power and allows government lawyers to pick and choose among prosecution targets.”).

10. See *United States v. O’Hagan*, 521 U.S. 642 (1997) (in which the U.S. Department of Justice successfully prosecuted a lawyer for insider trading on the basis of his misappropriation of material nonpublic information, validating the misappropriation theory of insider trading liability); *Chiarella v. United States*, 445 U.S. 222 (1980) (in which the U.S. Department of Justice’s insider trading prosecution of a “markup man” at a legal and financial printer was unsuccessful because of the lack of a requisite duty of trust and confidence, establishing the classical theory of insider trading liability); see also Macey, *Phony Insider-Trading*, *supra* note 8 (noting generally that “prosecutors enjoy almost unfettered discretion in deciding when and whom to prosecute”).

regulation, this article addresses an age-old jurisprudential question: how much enforcement discretion should the law afford the SEC and other enforcement agents (including the U.S. Department of Justice and private plaintiffs)?¹¹ Increased *ex ante* clarity in insider trading rules affords individual and institutional actors more certainty in their transactional decision-making but decreases the capacity for *ex post* enforcement discretion.

Recent, visible, significant insider trading enforcement and legislative activity¹² makes the issue of enforcement discretion in insider trading important and timely. Accordingly, this article addresses one element of enforcement discretion in U.S. insider trading regulation and offers a solution. Specifically, this article seeks to identify the appropriate level and type of guidance that should be provided on the concept of materiality as it is defined and applied in U.S. insider trading law through the “disclose or abstain” rule.¹³ Greater guidance on materiality in the context of the “disclose or abstain” rule will limit enforcement discretion in insider trading regulation. However, this more limited discretion need not compromise the policies underlying U.S. insider trading regulation. In fact, if properly conceived and crafted (i.e., not as a bright-line rule, but as a process for decision-making under the current materiality standard), enhanced materiality guidance should create a more efficient, and potentially more effective, system of insider trading regulation consistent with underlying policy.

11. See generally KENNETH CULP DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY (1971). Professor Davis writes:

The central inquiry . . . is what can be done to assure that where law ends tyranny will not begin. More precisely, the central inquiry is what can be done that is not now done to minimize injustice from exercise of discretionary power. . . . [W]e should eliminate much unnecessary discretionary power and . . . we should do much more than we have been doing to confine, to structure, and to check necessary discretionary power. The goal is not the maximum degree of confining, structuring, and checking; the goal is to find the optimum degree for each power in each set of circumstances.

Id. at 3–4.

12. See *SEC Enforcement Actions: Insider Trading Cases*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/spotlight/insidertrading/cases.shtml> (last modified Oct. 6, 2011) (“Insider trading continues to be a high priority area for the SEC’s enforcement program. The SEC brought 53 insider trading cases in FY 2010 against 138 individuals and entities, a 43 percent increase in the number of filed cases from the prior fiscal year.”).

13. See *infra* Parts I.C and II.

B. A Matter of Deference

In limiting enforcement discretion, materiality guidance also limits the range of discretion of the federal judiciary in materiality determinations. As a general matter (although courts apply the relevant law in various ways), federal courts in the United States defer to non-arbitrary, non-capricious legislative rulemaking by the SEC and other agencies if that rulemaking is expressly delegated to the agency and responds to and is consistent with the applicable legislative mandate.¹⁴ Moreover, where delegation of authority is not explicit, courts generally will defer to reasonable administrative agency interpretations of statutory provisions within the agency's regulatory mandate.¹⁵ Finally, federal courts also afford deference to a federal agency's interpretation of its own regulations.¹⁶ If the SEC were to adopt the materiality guidance proposed in this article, the federal courts may be bound to defer to the substance of that guidance. In evaluating the agency guidance proposed for adoption in this article, it is important to assess the extent to which judicial deference will be afforded to the guidance.

It also is important in this context to determine the status of the guidance as an agency rule from the standpoint of the U.S. Administrative Procedure Act ("APA").¹⁷

The APA recognizes a distinction between legislative rules and interpretative rules. The distinction is one of the most confusing in all of administrative law because legislative rules and interpretative rules differ along three different dimensions: the purpose of the rule, its legal effect, and the procedures used in promulgating the rule. In terms of purpose, a legislative rule can be defined as one that

14. *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837, 843–844 (1984) ("If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute" (footnote omitted)).

15. *See id.* at 844 (footnote omitted) ("Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.").

16. *See Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 413–414 (1945) ("Since this involves an interpretation of an administrative regulation a court must necessarily look to the administrative construction of the regulation if the meaning of the words used is in doubt. . . . [T]he ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation.").

17. 5 U.S.C. §§ 551–559 (2006).

articulates a new norm or modifies an existing norm, whereas an interpretative rule interprets or clarifies an existing norm. In terms of legal effect, a legislative rule is said to be legally binding on the regulated community the same way a statute is, while an interpretative rule may bind agency personnel, but does not bind the regulated community. In terms of procedure, legislative rules generally must be promulgated in accordance with public notice-and-comment procedures, whereas the APA exempts [interpretive] rules from these procedures. It is easy to see how the distinction between legislative and interpretative rules has led to confusion—different courts have distinguished between these rules on any and all of these three bases.¹⁸

So, is the suggested materiality guidance a legislative rule or an interpretive rule (a form of nonlegislative rule) under the APA?¹⁹

As a general matter, proposed guidance on materiality perhaps is best seen as an interpretive, rather than legislative, rule under the APA. However, the materiality guidance proposed in this article may be seen—or cast—as either a legislative or nonlegislative rule. It is not intended to provide “a new norm”²⁰ or change “an existing norm.”²¹ Rather, it is intended to arrange existing norms into a more coherent framework for applying the existing materiality standard as established in decisional law. As a result, the guidance “interprets or clarifies an existing norm.”²² However, as envisioned in this article, the proffered materiality guidance—sets of

18. Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain*, 89 GEO. L.J. 833, 903 (2001) (footnotes omitted). This explanation is useful (and helpful here), but it is not the only explanation of the distinction. For example, another scholar offers the following to explain the difference.

A legislative rule is essentially an administrative statute—an exercise of previously delegated power, new law that completes an incomplete legislative design. Legislative rules frequently prescribe, modify, or abolish duties, rights, or exemptions. In contrast, nonlegislative rules do not exercise delegated lawmaking power and thus are not administrative statutes. Instead, they provide guidance to the public and to agency staff and decisionmakers. They are not legally binding on members of the public.

Michael Asimow, *Nonlegislative Rulemaking and Regulatory Reform*, 1985 DUKE L.J. 381, 383 (footnotes omitted).

19. A third possibility should be noted here: that of a policy—another form of nonlegislative rule. This option is addressed briefly *infra* note 189 and accompanying text.

20. *Id.*

21. *Id.*

22. *Id.*

alternating presumptions and *per se* rules addressing two different factual scenarios—is intended “to be legally binding on the regulated community the same way a statute”²³ that engages those procedures would be (although it is not common to have statutes that engage serial presumptions to define an operative term). Accordingly, the status of the proposed materiality guidance as a legislative or interpretive rule under the APA is inconclusive.

The way in which the SEC promulgates the guidance may affect its status as a legislative or interpretive rule.²⁴

When an agency has a choice to proceed legislatively or nonlegislatively, its contemporaneous description is the most reliable test of what it actually did. Because an agency can choose to interpret law or limit discretion through legislative rulemaking, nonlegislative rulemaking, adjudication, or other techniques, it is appropriate to accept the agency’s description of which alternative it chose at the time it made the choice. Deference to the agency’s label also promotes certainty and predictability of result and provides agencies with reasonable assurance that reviewing courts will honor their decision to proceed nonlegislatively. Thus, an agency’s contemporaneously-adopted description of its intention and desired legal effect is and should be of central importance in characterizing its product.²⁵

Although courts are not bound by the agency’s description of its own rule as legislative or nonlegislative, that description can be helpful guidance to the court in exercising its decision-making authority.²⁶

SEC interpretive guidance on materiality should be given deference by the federal courts, whether it is viewed as a legislative rule or an agency interpretation of the congressional or SEC rules embodying U.S. federal insider trading prohibitions. Congress delegated broad express authority to the SEC to make rules under Section 10(b) (“Section 10(b)”) of the Securities Exchange Act of 1934, as amended (the “1934 Act”).²⁷ These rules

23. *Id.*

24. *See* Asimow, *supra* note 18, at 389 (“In many instances, an agency can choose to proceed legislatively or nonlegislatively, and there can be little dispute over the characterization of the resulting product: The agency explicitly declares that it intends to act either legislatively or nonlegislatively and that declared intention corresponds with the legal effect of the rule.”).

25. *Id.* at 389–90 (footnotes omitted).

26. *See id.* at 390.

27. 15 U.S.C. § 77j(b) (2006) (making it unlawful “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or

are the foundation for most U.S. federal insider trading regulation.²⁸ Adding detail to the judicially constructed definition of materiality in a manner that better effectuates the purpose of insider trading regulation under Section 10(b) and related SEC rulemaking is neither arbitrary nor capricious and, by its nature, would be consistent with both the statutory provision and SEC rulemaking under the statute, as interpreted in decisional law. Federal courts should give effect to the SEC's views on the application of materiality doctrine because it represents expert guidance on existing law and rules within the SEC's area of authority.

While federal court deference to SEC guidance on materiality constrains the freedom of judicial decision-making in materiality determinations, constraint is part of Congress's statutory plan, in which it expressly delegated implementation of Section 10(b) to the SEC in the statute.²⁹ This judicial deference to SEC guidance on materiality, like the limitation on enforcement discretion resulting from that guidance, need not compromise the policies underlying U.S. insider trading doctrine and holds the promise of creating a more efficient, and potentially more effective, system of regulation that is consistent with underlying policy.

C. The Relevant Legal Doctrine: "Disclose or Abstain" and Materiality

The judge-made "disclose or abstain" rule is the substantive focal point of U.S. insider trading regulation³⁰ under Rule 10b-5,³¹ the principal anti-fraud rule adopted by the SEC under Section

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" (emphasis added)).

28. See *infra* Part I.C.

29. See *supra* note 21 and accompanying text.

30. See Stephen M. Bainbridge, *Insider Trading under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1, 4 (1993) ("The so-called disclose or abstain rule is the basic federal insider trading prohibition."); 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, 1129 (1999) ("For more than thirty-eight years, the so-called 'disclose or abstain' rule has been an integral part of the insider trading prohibition imposed by the federal securities laws.").

31. 17 C.F.R. § 240.10b-5 (2012). The SEC has adopted two additional insider trading rules under its authority to make rules implementing Section 10(b): Rules 10b5-1 and 10b5-2. 17 C.F.R. §§ 240.10b5-1 & 240.10b5-2.

10(b) (“Rule 10b-5”).³² The “disclose or abstain” rule provides that when an issuer of publicly traded securities³³ or one of its insiders³⁴ 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.³⁵ Most insider trading claims are raised under Rule 10b-5 and involve the application and interpretation of this rule.³⁶ Although the materiality of undisclosed information is quite clear in some cases; in others, materiality is contestable and may be determinative. It is this latter class of cases that motivates this article.

The concept of materiality, which is central to the “disclose or abstain” rule,³⁷ is defined by use of a broad, judicially constructed

32. 15 U.S.C. § 78j(b).

33. Publicly traded securities, for these purposes, are securities that are registered under Section 12 of the 1934 Act. 15 U.S.C. § 78l.

34. In general, an “insider” is an individual or entity that has a relationship of “trust and confidence” with the issuer’s shareholders. *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

35. See, e.g., Bainbridge, *supra* note 30, at 4 (“A trader who possesses material, nonpublic information must either disclose it to the investment public before trading, or if he is unable to do so, must abstain from trading in the affected company’s securities.”); Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 456 (2003) (“Under the duty to disclose or abstain, a person in knowing possession (or ‘aware’) of material nonpublic information must either disclose the information or abstain from trading when the other party to the transaction is entitled to know the information because of a fiduciary duty or other relationship of trust and confidence between them.”); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 623 (1988) (“Federal law prohibits insiders from trading on the basis of nonpublic information not disclosed to the person with whom they are trading.”).

36. See Fried, *supra* note 35, at 456 (“The primary mechanism for regulating insider trading is the duty to ‘disclose or abstain,’ which arises under Rule 10b-5 of the Securities Exchange Act of 1934.”). A violation of Section 10(b) requires manipulative or deceptive conduct. 15 U.S.C. § 78j(b). Contravention of the “disclose or abstain” rule constitutes the requisite deception. See Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1615 (1999) (“[I]nsider trading in violation of the disclose or abstain rule involves an element of deception.”); Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 562 (2011) (“The insider trading prohibition is often described as a ‘disclose or abstain’ rule because there is no deception, and thus no fraud, if the seller/buyer tells her counterparty about the particular inside information she uses to trade.”).

³⁷ “The *sine qua non* of any insider trading claim is material nonpublic information.” Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & BUS. 151, 154 (2011).

standard.³⁸ Specifically, under Rule 10b-5 (both within and outside of the insider trading context), a fact is material when there is a substantial likelihood that (a) a reasonable investor would find the fact important in making an investment decision or (b) disclosure of the fact would significantly alter the “total mix” of publicly available information.³⁹ In the context of preliminary merger discussions, where consummation of the subject merger is uncertain, a more tailored test exists, in which the probability of the potential transaction occurring is weighed against the magnitude of the potential transaction.⁴⁰ This balancing test is widely applied by courts, litigants, and other actors in other circumstances involving the disclosure or nondisclosure of current facts relating to contingent or speculative events.⁴¹ These facially simple articulations of a materiality standard make for difficult *ex ante* and *ex post* materiality determinations in many cases and allow for the exercise of significant enforcement discretion and hindsight bias by enforcement agents and judicial decision-makers.⁴²

In an earlier article (the “Initial Materiality Article”), this author argued for additional substantive guidance for making

38. See Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83, 107 (2000) (“[T]he materiality concept speaks broadly to require disclosure of any information that a ‘reasonable shareholder’ would consider ‘important.’”).

39. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (applying, under Rule 10b-5, the alternative materiality formulations endorsed by the Court in *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

40. *Id.* at 239.

41. See, e.g., *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1265 (10th Cir. 2001) (assessing the materiality of pending litigation); *United States SEC v. Fehn*, 97 F.3d 1276, 1291 (9th Cir. 1996) (regarding the materiality of contingent liabilities); *PPM Am. v. Marriott Corp.*, 853 F. Supp. 860, 868 (D. Md. 1994) (governing the materiality of a “major change in corporate form”); *Wielgos v. Commonwealth Edison Co.*, 688 F. Supp. 331, 343 (N.D. Ill. 1988) (determining the materiality of a licensing board’s determination regarding an operating permit). The *Basic* Court expressly disclaimed that its adoption of the balancing test for the purpose of assessing the materiality of preliminary merger discussions constituted a broader adoption of the test for use in other circumstances involving contingent or speculative events. *Basic*, 485 U.S. at 232 n.9.

42. See Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 774 (2004) (“Hindsight blurs the distinction between fraud and mistake. People consistently overstate what could have been predicted after events have unfolded . . .”). Some judges disclaim that their materiality determinations are being made with the benefit of hindsight. See *id.* at 809.

materiality determinations in the insider trading context.⁴³ The argument for change set forth in that article is based on both underlying policy and related shareholder value considerations,⁴⁴ although other rationales for additional materiality guidance in various stock-trading contexts also have been advanced. For example, arguments for enhancing materiality guidance under Regulation FD⁴⁵ tend to focus on the fact that the lack of guidance fosters nondisclosure in circumstances where disclosure should be encouraged.⁴⁶ Professor Steve Schwarcz effectively argues that the ambiguity in materiality determinations causes a temporal problem in that it forces corporations contemplating disclosure to choose between the maximization of short-term shareholder value and the maximization of long-term shareholder value.⁴⁷ Professor James Park argues that imprecision in the existing qualitatively oriented materiality standard “expands the potential cost of defending securities fraud actions relating to accounting misstatements, especially for companies when they are issuing securities.”⁴⁸ Professor Steven Davidoff similarly proclaims that materiality is outdated and lacking in current investor relevance.⁴⁹ Finally, accountants argue that the lack of a concrete definition of materiality creates undesirable behavioral effects.⁵⁰

43. Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131 (2003) (reprinted at 36 SEC. L. REV. 448 (2004)).

44. See *id.* at 1140–43 (summarizing these arguments); Donald C. Langevoort, *Editor’s Introduction*, 36 SEC. L. REV. 20 (2004) (noting the argument that ambiguity in the materiality standard used in insider trading regulation “is not necessary to promote the underlying policy goals of the insider trading prohibition and the uncertainty negatively impacts shareholder value”).

45. 17 C.F.R. § 243.100–103 (2012).

46. Laura Unger, Commissioner, *Special Study: Regulation Fair Disclosure Revisited*, U.S. SEC. & EXCH. COMM’N (December 2001), available at <http://www.sec.gov/news/studies/regfdstudy.htm> (last modified Oct. 29, 2003).

47. Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044 (2005).

48. James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 531 (2009).

49. Steven M. Davidoff, *In Corporate Disclosure, a Murky Definition of Material*, N.Y. TIMES DEALBOOK, April 5, 2011, <http://dealbook.nytimes.com/2011/04/05/in-corporate-disclosure-a-murky-definition-of-material/> (“[T]he current disclosure scheme and its definition of materiality . . . is increasingly disconnected from the desires of investors and the marketplace. . . . The definition of materiality is from the 1980s, another time.”).

50. See Andrew A. Acito et al., *Materiality Decisions and the Correction of Accounting Errors*, 84 ACC’TING REV. 659, 660 (2009) (“The absence of bright-line criteria means that some materiality decisions may be strategic in their purpose”); see also *id.* at 664 (“Because GAAP does not provide bright-line rules for determining materiality, management and auditors must jointly

These issues with the current materiality standard are particularly troublesome in the context of insider trading.

[T]he concept of materiality as implemented in U.S. insider trading regulation has created unique planning problems for public companies and their insiders. 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.⁵¹

The open-textured disclosure environment of insider trading in which materiality operates is of particular concern when it mixes with enforcement discretion. Enforcement agents may exercise their discretion to enforce insider trading prohibitions against some buyers, sellers, tippers, or tippees—and not others—for reasons unrelated to the policy objectives underlying insider trading regulation. For example, the SEC and other public enforcement agents may conduct their activities in part to develop the law of materiality.⁵² Also, in an earlier work, this author noted that the vagueness of aspects of the legal standard for insider trading liability under Rule 10b-5 (including the materiality element), when paired with the broad enforcement discretion available in the insider trading enforcement process, invites the introduction of

negotiate a subjectively determined . . . materiality assessment on a case-by-case basis. This approach leaves open the possibility that some assessments are opportunistic and designed to achieve financial reporting and disclosure goals.”).

51. Heminway, *supra* note 43, at 1135. See also Peter J. Henning, *Insider Trading Riddle: Why Do the Rich Risk It?*, N.Y. TIMES DEALBOOK, Apr. 4, 2012, <http://dealbook.nytimes.com/2012/04/04/insider-trading-riddle-why-do-the-rich-risk-it/?ref=securitiesandexchangecommission> (identifying materiality as a key component of U.S. insider trading regulation).

52. See, e.g., Bondi & Lofchie, *supra* note 37, at 200 (“Because the law has developed in the courts . . . insider trading law is fluid and continues to evolve as markets grow, technology changes, and the DOJ and SEC press new theories of insider trading.”); David L. Komblau & Brian B. Alexander, *Recent Developments in the Law of Insider Trading and Material Nonpublic Information*, SIFMA Compliance & Legal Society 2011 Annual Seminar (March 7, 2011), at 9, available at <http://www.cov.com/files/Publication/5bd8d976-2faa-490a-86a1-ac2265dd9bc4/Presentation/PublicationAttachment/cbc992cb-aa02-42d1-95a9-b019dc56ede3/Recent%20Developments%20in%20the%20Law%20of%20Insider%20Trading%20and%20Material%20Nonpublic%20Information.pdf> (noting that “the SEC continues to push the envelope of materiality in its insider trading program”).

enforcement biases.⁵³ In general, enforcement agents believe it is in their best interest to preserve discretion by leaving materiality and other key concepts and terms vague and by self-defining these words and terms to suit their needs as the time arises. In commenting on a recent case, Professor Peter Henning aptly summarizes the relationship between the SEC and enforcement discretion relating to materiality in the context of mergers and acquisitions:

The S.E.C. takes an aggressive view of materiality. . . . It has avoided drawing any clear lines around what is—and is not—material information about mergers and acquisitions because that might encourage trading by those who learn about a potential deal in the early stages. For the S.E.C., all information is potentially material, and a flexible approach is in its interest.⁵⁴

The relationship between unclear regulation and enforcement discretion is advantageous to federal agencies charged with enforcing the law in the areas of regulatory mandate. It allows enforcement agents to use enforcement as a regulatory tool. As a result, the desire for broad enforcement discretion is not unique to insider trading regulation or the SEC.⁵⁵ The obvious benefit of

53. Joan MacLeod Heminway, *Save Martha Stewart? Observations About Equal Justice in U.S. Insider Trading Regulation*, 12 TEX. J. WOMEN & L. 247 (2003).

54. Peter J. Henning, *The Materiality of Merger Negotiations*, N.Y. TIMES DEALBOOK, Apr. 4, 2011, <http://dealbook.nytimes.com/2011/04/04/the-materiality-of-merger-negotiations/>.

55. See, e.g., John Ashcroft & John Ratcliffe, *The Recent and Unusual Evolution of an Expanding FCPA*, 26 NOTRE DAME J. L. ETHICS & PUB POL'Y 25, 34 (2012) (“[E]ven the most basic elements of the FCPA, like what constitutes a ‘bribe’ or who is considered a ‘foreign official,’ remain largely undefined. As a result, it would appear that prosecutors are unfettered in their discretion to extend the boundaries of FCPA interpretation to fit the facts and circumstances of any particular investigation.”); John S. Baker, *Jurisdictional and Separation of Powers Strategies to Limit the Expansion of Federal Crimes*, 54 AM. U.L. REV. 545, 570 (2005) (“Congress has left great discretion to the Executive in prosecution by enacting broad and often ambiguous criminal statutes.”); Michael S. Kelley, *“Something Beyond”: The Unconstitutional Vagueness of Rico’s Pattern Requirement*, 40 CATH. U.L. REV. 331, 392 (1991) (“RICO’s pattern requirement threatens fifth amendment freedoms by combining an ambiguous term with a statute granting tremendous discretion to prosecutors and private plaintiffs.”); Joan H. Krause, *Medical Error as False Claim*, 27 AM. J. L. & MED. 181, 197 (2001) (“The current health care regulatory environment is characterized by ambiguous rules that do not adequately address the realities of the health care market, relying on prosecutorial discretion to distinguish improper activities from harmless (or even efficient) behavior.”); Michael J. Malinowski, *Globalization of*

enforcement discretion in this context is that it affords enforcement agents the opportunity to mold their enforcement strategies and efforts to fit new, unforeseen factual contexts.

It is possible for an enforcement agent to have too much discretion, however. More is not necessarily better. The Initial Materiality Article raises questions in this regard based on shareholder value considerations.⁵⁶ Vagueness in applied materiality doctrine may also raise other economic efficiency concerns and may weaken, rather than strengthen, the deterrence value of the regulatory regime.⁵⁷ While some efficient, desirable securities transactions will go forward despite the risk of potential enforcement, many will be discouraged by that risk. An efficacious insider trading regime under current U.S. law should enable

Biotechnology and the Public Health Challenges Accompanying It, 60 ALB. L. REV. 119, 169 (1996) (“[A]ccording to some accounts, FDA officials have all the power and discretion they need, and this discretion is enhanced by the ambiguity of the regulations they enforce.”).

56. See Heminway, *supra* note 43, at 1172–90.

57. Various scholars have written on this point. I will share the thoughts of two here. Professor Marlene O’Connor notes that

a specific rule enhances the efficiency of a deterrence strategy in two ways. First, precise regulations have an impact on the cost side of the potential violator’s risk-reward equation. Because a specific rule employs very few factual issues to determine whether certain activity is illegal, it increases the likelihood that the defendant’s conduct will fall within its narrow parameters and thus be deemed illegal. In addition, because a specific rule does not provide for discretionary exceptions, it also raises the probability that the defendant will be convicted for engaging in the illegal activity. Second, a specific rule reduces the amount of resources the enforcement system consumes in prosecuting violators. A precise rule promotes deterrence and decreases the number of violations that occur; thus it lowers the amount of resources required for the detection of the illegal activity and the total number of cases brought before the judicial system. Specific regulation also conserves judicial resources, because cases concerning a specific rule involve only a few factual issues that take less time to litigate. Given only a limited number of facts to dispute, parties can more accurately predict the outcome of litigation; thus, a specific rule also increases the likelihood that parties will settle their disputes outside the court system.

Marleen A. O’Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 359 (1989) (footnotes omitted). Professor Dru Stevenson raises a similar point, noting that “[w]hen people feel the law or sanctions are not just unknown, but unknowable, they will either be overly cautious and reclusive (avoiding too many useful activities) due to the ‘chilling effect,’ or overly careless about the consequences of their actions, creating significant externalities for society.” Dru Stevenson, *Toward a New Theory of Notice and Deterrence*, 26 CARDOZO L. REV. 1535, 1547–1548 (2005).

enforcement against those in positions of trust and confidence who desire to misuse significant, market-relevant information by appropriating it for personal benefit rather than releasing it to the market—no more, no less. When the breadth of enforcement discretion creates collateral damage (in terms of economic inefficiencies, deterrence failures, or otherwise) and that enforcement discretion can be constrained without compromising the efficacy of the scheme of regulation, then rule makers should consider placing appropriate limits on enforcement discretion.⁵⁸

D. Decreasing Enforcement Discretion Through Materiality Guidance

While a bright-line materiality definition would certainly cabin enforcement discretion in insider trading regulation (and be a likely candidate for judicial deference), this article does not argue for a bright-line rule. Instead, this article contends that materiality guidance can be formulated based on a series of presumptions derived from existing decisional law, agency pronouncements, and scholarly commentary. Although this article offers guidance only in two common insider trading scenarios, similar guidance could be constructed over time to address other facts and circumstances giving rise to potential insider trading claims. The overall idea is to provide individuals who possess material nonpublic information in a duty-bound context with more certain, predictable, consistent instructions on how to conduct their trading activities—activities that may contribute to healthy, efficient capital markets. Currently, these desirable trading activities may be avoided in an abundance of caution.⁵⁹

The Initial Materiality Article proposes a method for constructing the desired materiality guidance.⁶⁰ This proposal required that the proponent of the guidance: (1) isolate factual circumstances in the insider trading context in which materiality guidance routinely is needed; (2) identify the elements of materiality that are operative under those circumstances and the ways in which the materiality of each element is measured (based

58. *Accord* Ashcroft & Ratcliffe, *supra* note 55, at 34 (“While it is understood that laws are rarely black and white, our adversarial system of justice is not well served when the roles of prosecutor and judge are combined, and where the resulting law remains perpetually gray. For corporate America, the dilemma is obvious—it is difficult for any company to ensure that its employees and business partners will act ethically and legally when it is unclear which actions will trigger [a] . . . violation.”).

59. *See* Heminway, *supra* note 43, at 1174–77.

60. *Id.* at 1193.

on the applicable legal standard and existing line-item disclosure rules and decisional law); and (3) incorporate each materiality element and measurement technique into guidance on materiality applicable to the isolated factual circumstances.⁶¹

The Initial Materiality Article leaves two important items for future resolution, however. First, it does not resolve which federal rulemaking institution would or should adopt specific proposals for materiality guidance in the insider trading context, stating that “[w]hether that guidance comes in the form of legislation, SEC rulemaking, SEC interpretive advice, or (at a bare minimum) more methodical, rigorous decision-making in the courts, enhanced guidance is warranted.”⁶² In fact, the Initial Materiality Article expressly indicates that this question of comparative institutional choice could be resolved in a separate scholarly work.⁶³ Accordingly, in a subsequent article (the “Institutional Choice Article”), this author began to take on that task by proposing a standardized framework for making comparative institutional choice decisions in federal corporate governance rulemaking (including insider trading rulemaking).⁶⁴ This framework involves comparative institutional analyses in four separate areas: institutional capacity—power, authority, and jurisdiction;⁶⁵ structural and substantive institutional competence;⁶⁶ institutional influence and bias;⁶⁷ and pecuniary cost.⁶⁸ The Institutional Choice Article does not expressly address, however, the application of the suggested framework to a specific proposal for additional guidance on materiality in insider trading law.

Second, largely because the Initial Materiality Article does not resolve essential issues of comparative institutional choice, it fails to recommend the specific type and content of the proposed enhanced materiality guidance. Instead, using the method it outlines, the Initial Materiality Article suggests the possible substantive and procedural contents of materiality guidance in two sets of factual circumstances: irregularities in balance sheet accounting and failed merger discussions.⁶⁹ These suggestions

61. *Id.*

62. *Id.* at 1191–92.

63. *Id.* at n.219.

64. Joan MacLeod Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, 10 *FORDHAM J. CORP. & FIN. L.* 225 (2005).

65. *Id.* at 248–62.

66. *Id.* at 262–307.

67. *Id.* at 307–32.

68. *Id.* at 332–48.

69. Heminway, *supra* note 43, at 1199–1210.

require refinement, enhancement, and institutional packaging before they can constitute formal proposals for legal change.

This article engages in that refinement, enhancement, and institutional packaging, and in the process, makes certain adjustments to the guidance proposed in the Initial Materiality Article. This article also both analyzes and determines the appropriate rulemaking body and proposes the form in which the materiality guidance should be adopted and published. To accomplish these objectives, the article proceeds in four additional parts. Part II summarizes, clarifies, and modifies the approaches to materiality guidance on balance sheet irregularities and failed merger discussions that are suggested in the Initial Materiality Article. Specifically, Part II describes detailed processes through which materiality can be assessed by relevant actors *ex ante* and *ex post* in two common factual circumstances (balance sheet irregularities and failed merger discussions). Part III then presents a comparative institutional analysis, as outlined in the Institutional Choice Article, with respect to the proposed materiality guidance and concludes that the SEC or, failing that, the courts should adopt that guidance. As a result of this outcome of the comparative institutional analysis, Part III concludes by describing the current political and economic environment in which the SEC is operating. Part IV describes the form of a proposed SEC interpretive release to implement that guidance, and Part V summarizes and briefly concludes.

II. FURTHER GUIDANCE ON MATERIALITY IN INSIDER TRADING REGULATION

The Initial Materiality Article features difficult, indeterminate materiality analyses in two common factual contexts and suggests possible structures for enhanced guidance in those two contexts. This Part reintroduces those examples and the related guidance structures. The guidance structures are expressly intended to enable transaction planners,⁷⁰ litigants, and their counsel, as well as enforcement officials and members of the judiciary, to make materiality assessments in the two exemplar areas with a higher level of certainty. If the guidance is effective, costs incident to

70. In the Initial Materiality Article, this term is defined to include “any issuer of securities, any insiders of that issuer, and their respective advisors on any transaction at issue, including without limitation legal counsel.” *Id.* at 1137 n.19. Importantly, the Initial Materiality Article and this article both include issuers, as well as directors, officers, and others with a relevant duty of trust and confidence in the class of potential violators of insider trading law.

making materiality determinations should be reduced, vexatious litigation challenging materiality determinations should be filed less frequently, and if a specious case hinging on materiality is brought, it should be decided more easily on a motion to dismiss or for summary judgment.⁷¹ It is important to note, however, that the rules and presumptions comprising this guidance are intended as advice and assistance to transaction planners and others, rather than (necessarily) as determinants of legal liability. However, it also is important to note that the presumptions in the guidance are crafted to be within, rather than at the edge of, the range of legal compliance. Insider trading compliance plans, for example, are similarly crafted to be within the range of legal compliance.⁷²

The proffered guidance may be adopted by the federal courts, Congress, or the SEC—all of which are insider trading rule makers. But adoption of materiality guidance through the judicial process would occur incrementally through decisional law over time (much as it has in the past). The appropriate rule maker for and nature of the guidance will be addressed in detail in Part III. However, it is worth noting here (in evaluating the propriety and efficacy of the substance of the guidance as set forth in this Part) that the choice of rule maker may render the proposed guidance more or less feasible and more or less legally binding on the potential actors *ab initio* and over time.

A. Improper Balance Sheet Accounting

The first exemplar factual context in the Initial Materiality Article involves a public company's reckless financial statement error—the understatement of balance sheet reserves, resulting in a corresponding two percent overstatement of assets.⁷³ Before the error is expressly identified and corrected in public filings, the public company's Chief Financial Officer exercises stock options and sells the underlying shares. In this example, there exists a concern that the Chief Financial Officer may have been in possession of material nonpublic information—the true (lower) value of the corporation's assets—at the time she sold her shares into a public market that then had no awareness of the lower asset

71. Of course, in any given case, other elements of an insider trading claim also may be at issue.

72. See generally Joan T.A. Gabel et al., *Letter vs. Spirit: The Evolution of Compliance into Ethics*, 46 AM. BUS. L.J. 453, 462 (2009) (describing insider trading compliance programs); Steven Chasin, Comment, *Insider v. Issuer: Resolving and Preventing Insider Trading Compliance Policy Disputes*, 50 UCLA L. REV. 859, 861-64 (same).

73. See Heminway, *supra* note 43, at 1145-46.

valuation. In this manner, she would be deemed to have profited personally from the nondisclosure of the adverse corporate financial information.

Having presented this example, the Initial Materiality Article proceeds to determine that a materiality analysis based on these facts does not result in a clear conclusion. Then, it outlines and applies a recommended approach to fashioning more specific materiality guidance applicable to these (and other similar) facts. The application of this approach results in the suggestion that

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 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).⁷⁴

This suggestion was intended to provide a basic framework for guidance, but the numerical thresholds at five percent and ten percent of total consolidated assets are at odds with accounting convention (which is relevant, although not dispositive, to the legal assessment of materiality). While income threshold tests for materiality typically hover in this range,⁷⁵ asset tests tend to be set

74. *Id.* at 1203–04.

75. See Seong-Yeon Cho et al., *Measuring Stockholder Materiality*, ACCT. HORIZONS 63, 64 (2003 Supp.) (“Items less than 5 percent of net income are generally considered immaterial, while items greater than 10 percent are considered material.”); Mark W. Nelson et al., *The Effect of Quantitative*

at significantly lower thresholds—more in the order of one-half percent of net assets. Investor tolerance for materiality may, however, be lower.⁷⁶

The Initial Materiality Article assumed that there was no significant income statement effect caused by the improper balance sheet accounting example presented.⁷⁷ This assumption and the related focus on an asset-oriented test for materiality prove to be faulty from an accounting point of view. For accountants, quantitative materiality typically is gauged by reference income statement data, first and foremost, although asset tests may be employed in specific circumstances (including where assets are a better point of reference because of the nature of the corporation or its financial statements).⁷⁸ That being the case, the suggested materiality guidance in the Initial Materiality Article should be recast to focus on income statement thresholds. Accordingly, this article re-proposes the suggested guidance for improper balance sheet accounting. Specifically, materiality guidance on improper balance sheet accounting could be constructed to: (i) render *per se* material all misstatements (taken individually or collectively for any given reporting period) in excess of ten percent of the issuer's net income before taxes, based on the most recently reported income statement of the issuer; (ii) presume material all misstatements (taken individually or collectively for any given reporting period) of at least five percent, but not in excess of ten percent, of the issuer's net income before taxes, based on the most recently reported income statement of the issuer (which presumption is rebuttable by the trading issuer or insider based on a list of specified factors derived from current law, regulation, and guidance); and (iii) presume immaterial all misstatements (taken individually or collectively for any given total reporting period) of

Materiality Approach on Auditors' Adjustment Decisions, 80 ACCT. REV. 897, 900 (2005) (“[Q]uantitative thresholds such as 5–10 percent of net income have long been used in practice”); James Brady Vorhies, *The New Importance of Materiality*, J. OF ACCT. (May 2005), available at <http://www.journalofaccountancy.com/Issues/2005/May/TheNewImportanceOfMateriality.htm> (“Working materiality levels or quantitative estimates of materiality generally are based on the 5% rule, which holds that reasonable investors would not be influenced in their investment decisions by a fluctuation in net income of 5% or less.”).

76. See Cho et al., *supra* note 75, at 65 (“We infer from our results that the average investor materiality threshold for pretax earnings is between 0.1 percent and 0.2 percent. For total assets, we estimate a materiality threshold between 0.01 percent and 0.025 percent.”).

77. See Heminway, *supra* note 43, at n.246.

78. See WILLIAM F. MESSIER ET AL., *AUDITING AND ASSURANCES: A SYSTEMATIC APPROACH* 87 (6th ed. 2007).

less than five percent of the issuer's net income before taxes, based on the most recently reported income statement of the issuer (which presumption is rebuttable by the trading issuer or insider based on a list of specified factors derived from current law, regulation, and guidance).

Overall, this guidance represents a more concrete way to approach the problem of financial statement misstatements and is not inconsistent with the SEC's *Staff Accounting Bulletin: No. 99 – Materiality*.⁷⁹

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that—without considering all relevant circumstances—a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a “rule of thumb” as an initial step in assessing materiality.⁸⁰

The reformulated materiality guidance suggested in this article accepts the concept of a rule of thumb for quantitative measures materiality and provides a specific process for how qualitative factors can then be assessed given those accounting industry norms. The reformulated guidance, however, leaves undetermined the referenced lists of applicable rebuttal factors, the applicable standards of proof on rebuttal, and the procedural effects of a rebuttal that satisfies the applicable standards of proof.⁸¹ These matters are addressed in the remainder of Part II.A.

1. Rebuttal Factors

Based on existing administrative and judicial pronouncements and scholarly commentary, the factors set forth below may rebut a presumption of materiality in the event of asset misstatements that

79. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999) [hereinafter SAB No. 99]. SAB No. 99 is a publication of the SEC's staff that does not represent formal guidance from the SEC but it is used by the SEC in its work and is given significant, but not dispositive, weight by the judiciary, legal advisors, and transaction planners. See Bondi & Lofchie, *supra* note 37, at 181 (“Although the SEC often cites SAB 99 in its pleadings, the bulletin is not the adopted view of the SEC (i.e., the Commission has not voted on it). It is merely an official interpretation of the staff and, therefore, should not be given undue authoritative weight.”).

80. SAB No. 99.

81. See *infra* Parts II.A.1 & II.A.2.

cause a change of at least five percent, but not in excess of ten percent, in an issuer's net income before taxes:

- the action (tipping or trading) of the issuer or insider is counterintuitive to the misstatement (i.e., the misstatement results in a decrease in net income before taxes and the issuer or insider acquires shares before the misstatement is publicly announced, or the misstatement results in an increase in net income and the issuer or insider sells shares before the misstatement is publicly announced);⁸²
- net income before taxes is not a significant factor in market assessments of the issuer's operations or financial condition because of, for example, the nature of the issuer's business;⁸³
- the misstatement relates to a business segment or other portion of the issuer's business that plays an insignificant role in the issuer's operations or financial condition;⁸⁴
- the misstatement arises from an estimate that is inherently imprecise at the order of magnitude of the misrepresentation;⁸⁵ and
- the misstatement results from calculations or measurements that, although made with reasonable care, are widely known to be, or that have been disclosed by the issuer to be, subject to inaccuracies of the type and amount exhibit in connection with the issuer's misstatement.⁸⁶

These factors collectively call into question both the relevance and the reliability of a misstatement that appears to be, in relative

82. Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 737 (1989) ("[W]hen an insider is buying, projections, asset appraisals, or pending merger negotiations that suggest an increase in the price of a corporation's stock are likely to be of more interest to the rational public transactor than unfavorable projections or asset appraisals. And when the insider is selling, the undisclosed unfavorable information about future prices is likely to be of more interest to the rational public transactor than undisclosed favorable information.").

83. See *supra* note 78 and accompanying text (noting that, while income tests are the norm for quantitative materiality assessments, asset tests or other benchmarks for quantitative materiality may be used where the validity of an income test is questionable).

84. Cf. SAB No. 99, *supra* note 79 (suggesting that the opposite—"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"—may render a small deviation material).

85. Cf. *id.* ("whether the misstatement . . . arises from an estimate and, if so, the degree of imprecision inherent in the estimate").

86. Cf. *id.* ("whether the misstatement arises from an item capable of precise measurement").

terms, quantitatively large.⁸⁷ Relevance and reliability are important components of materiality analysis.⁸⁸

Factors that may rebut a presumption of immateriality in the event of asset misstatements that cause a change of less than or equal to five percent in an issuer's net income before taxes include the following:

- the misstatement relates to a business segment or other portion of the issuer's business that is significant to the issuer's operations or financial condition;⁸⁹
- the misstatement arises from an estimate that is inherently imprecise at the order of magnitude of the misrepresentation;⁹⁰
- the misstatement hides a change in earnings or other income statement effect, especially one that changes income into a loss or a loss into income;⁹¹
- the misstatement hides the issuer's failure to meet publicly available financial statement targets (whether published by the issuer or third parties);⁹²
- the misstatement hides illegal activity;⁹³
- the misstatement hides or constitutes regulatory noncompliance;⁹⁴
- the misstatement hides or constitutes the breach of a "material contract;"⁹⁵

87. See Brudney, *supra* note 82, at 728–32.

88. *Id.* at 731 (identifying and defining relevance and reliability as key overarching factors in materiality analysis).

89. See SAB No. 99, *supra* note 79 (suggesting consideration of "whether the misstatement concerns a . . . portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability").

90. See *id.* ("whether the misstatement . . . arises from an estimate and, if so, the degree of imprecision inherent in the estimate").

91. See *id.* (suggesting consideration of "whether the misstatement masks a change in earnings or other trends" and "whether the misstatement changes a loss into income or vice versa"). The use of reserve account estimates as a way of adjusting earnings across financial statement periods is a well-known accounting technique. See LAWRENCE A. CUNNINGHAM, *INTRODUCTORY ACCOUNTING, FINANCE AND AUDITING FOR LAWYERS* 438 (4th ed. 2002) (describing "Cookie Jar Reserves").

92. See SAB No. 99, *supra* note 79 (suggesting consideration of "whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise").

93. See *id.* (suggesting consideration of "whether the misstatement involves concealment of an unlawful transaction").

94. See *id.* (suggesting consideration of "whether the misstatement affects the registrant's compliance with regulatory requirements").

95. Regulation S-K, 17 C.F.R. § 229.601(b)(10) (2012) (defining material contracts for purposes of SEC exhibit requirements); see SAB No. 99, *supra*

- the misstatement is of a kind and magnitude that financially benefits the issuer or its directors, officers, or other managers at the expense of the issuer's shareholders, including by increasing the directors', officers', or managers' actual, or potential future, compensation;⁹⁶
- the misstatement evidences a lack of management integrity;⁹⁷
- the accounting error that resulted in the misstatement evidences a material weakness in internal controls;⁹⁸ and
- the misstatement is persistent (not an isolated event).⁹⁹

The general approach recommended here employs both quantitative and qualitative materiality doctrine consistent with existing SEC guidance¹⁰⁰ and related scholarly commentary.¹⁰¹ The accounting literature and ever-evolving decisional law should be evaluated for additional rebuttal factors on a periodic basis.¹⁰²

note 79 (suggesting consideration of “whether the misstatement affects the registrant’s compliance with loan covenants or other contractual requirements”).

96. See SAB No. 99, *supra* note 79 (suggesting consideration of “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”).

97. See, e.g., *In re Franchard Corp.*, 42 S.E.C. 163 (1964); see also *SEC v. Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 830 (E.D. Wis. 1978); John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41, 46–47 (1998) (recounting the history of qualitative materiality doctrine); Amy Deen Westbrook, *Sunlight on Iran: How Reductive Standards of Materiality Excuse Incomplete Disclosure Under the Securities Laws*, 7 HASTINGS BUS. L.J. 13, 30–34 (2011) (recounting the history of management integrity issues and materiality doctrine).

98. A material weakness is “a deficiency, or a combination of deficiencies, in internal control over financial reporting . . . such that there is a reasonable possibility that a material misstatement of the registrant’s annual or interim financial statements will not be prevented or detected on a timely basis.” 17 C.F.R. § 210.1-02(a)(4) (2012). Section 404 of the Sarbanes-Oxley Act of 2002 focused attention on mandatory disclosures about internal controls in periodic reports filed under the 1934 Act. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 777–78 (2002) (codified at 15 U.S.C. § 7262 (2006)).

99. See Park, *supra* note 48, at 518 (suggesting, similarly, that “evidence of a persistent misstatement might create a rebuttable presumption of materiality while evidence that the misstatement is isolated might create a rebuttable presumption of immateriality.”); *id.* at 550–52 (expanding on the presumption suggestion).

100. See SAB No. 99, *supra* note 79.

101. See Park, *supra* note 48, at 565 (characterizing his own proposal as “a firmer basis for distinguishing the financial misstatements that matter”).

102. See, e.g., MESSIER ET AL., *supra* note 78, at 86 (listing possible rebuttal factors in Table 3-5, many of which parallel those in SAB No. 99, *supra* note 79).

2. *Standard of Proof and Procedural Effects*

A transaction planner using the proposed materiality guidance on improper balance sheet accounting will want to consider the standards to be applied in his, her, or its decision-making and the standards that may be used to evaluate his, her, or its decision-making *ex post*, even if the guidance is offered in the form of legislation or agency rulemaking. This involves identifying and taking into account the standards of proof in civil and criminal insider trading actions and the procedural effects of those standards.

An analysis of the standard of proof applicable to rebuttals of the presumptions and the effect of successful rebuttals requires understanding the application and operation of presumptions and rebuttals in the context of a court action. The standards of proof provide guidance to decision-makers in using the proposed materiality guidance and also frame potential court analyses if the court should be required, or otherwise determine, to adopt the guidance in evaluating the conduct of alleged insider traders.

Courts have different ways of looking at rebuttable presumptions in civil cases. Specifically, they

differ as to the effect that a presumption must be given in a civil action and the burden it imposes on the party opposing it. There are three different approaches taken by the courts One imposes only a *burden of production* or *going forward* with evidence to rebut the presumption. The second approach requires a more substantial *burden of proof* requirement. The third approach uses both the burden of production and burden of proof.¹⁰³

Which of the three approaches seems most appropriate in connection with the presumptions that operate in the proposed materiality guidance on improper balance sheet accounting?

The plaintiff in a civil action must prove materiality by a preponderance of the evidence. Is it sufficient, where an omission or misstatement is presumed to be material, that the defendant present evidence that a rebuttal factor exists to overcome the presumption, or should the defendant be required to prove the existence of that factor by a preponderance of the evidence? And is it sufficient, where an omission or misstatement is presumed to be immaterial, that the plaintiff present evidence that a rebuttal factor exists, or should the plaintiff be required to prove the existence of that factor by a preponderance of the evidence? Finally, should

103. THOMAS BUCKLES, *LAWS OF EVIDENCE* 56 (2001).

both presumptions be treated the same way, given that the burden of proof is on the plaintiff in a civil action?

Because the policies underlying the alternating presumptions in the proposed guidance on improper balance sheet accounting represent a careful balancing of interests (rather than a unilateral, fundamental determination to favor one party over another in insider trading litigation), the rebutting party in a civil case also should have to establish the rebuttal facts by a preponderance of the evidence. Accordingly, the establishment of any single rebuttal factor by a preponderance of the evidence removes the applicable presumption of materiality or immateriality, leaving the case to a determination at trial based on all available evidence appropriately brought before the court—with the plaintiff continuing to bear the burden of proof. The inability of a party to assert, in good faith, the existence of any rebuttal factor enables—but does not mandate—a trier of fact to find facts consistent with the presumption (i.e., against the party entitled to rebut the presumption). In the rare case that a rebutting party is able to establish one or more rebuttal factors by clear and convincing evidence, the trier of fact may determine that the rebuttal is compelling enough to find facts contrary to the presumption. Accordingly, putative rebutters should secure and preserve any evidence relating to the rebuttal of an operative presumption and should evaluate proposed action based on the weight of that evidence.

The application of a *per se* rule (also known as a conclusive or mandatory presumption) or rebuttable presumption in a criminal proceeding is not as straightforward as the application of a *per se* rule or rebuttable presumption is in a civil proceeding and may raise constitutional issues. Although a thorough analysis of these issues is beyond the scope of this article, it is important to say a few words about their relevant components at this juncture.

Under criminal law principles, as even non-lawyers know, a defendant is innocent until proven guilty. Criminal actions require proof beyond a reasonable doubt of each element of the crime. Accordingly, conclusive and rebuttable presumptions of any element necessary to establish a criminal violation are scrutinized carefully for their effects on the burden of proof.

A mandatory presumption is a . . . troublesome evidentiary device. For it may affect not only the strength of the “no reasonable doubt” burden but also the placement of that burden; it tells the trier that he or they must find the elemental fact upon proof of the basic fact, at least unless the defendant has come forward with some evidence to rebut the presumed connection between the two facts. In

this situation, the Court has generally examined the presumption on its face to determine the extent to which the basic and elemental facts coincide. To the extent that the trier of fact is forced to abide by the presumption, and may not reject it based on an independent evaluation of the particular facts presented by the State, the analysis of the presumption's constitutional validity is logically divorced from those facts and based on the presumption's accuracy in the run of cases. It is for this reason that the Court has held it irrelevant in analyzing a mandatory presumption, but not in analyzing a purely permissive one, that there is ample evidence in the record other than the presumption to support a conviction.¹⁰⁴

The presumptions suggested in the proposed materiality guidance on improper balance sheet accounting would be "merely a part of the prosecution's case"¹⁰⁵ giving "rise to a permissive inference available only in certain circumstances . . . that . . . could be ignored by the jury even if there was no affirmative proof offered . . . in rebuttal."¹⁰⁶ Assuming that the trier of fact understands or is instructed that there is a mandatory presumption of innocence in favor of the defendant "that controls unless it, as the exclusive trier of fact, is satisfied beyond a reasonable doubt"¹⁰⁷ the facts at issue are material, the suggested presumptions should pass constitutional muster.

However, the *per se* materiality rule raises constitutional questions in criminal actions. Under the proposed guidance, all asset or liability omissions or misstatements that cause a change of more than ten percent in the issuer's net income before taxes, are material. This rule would act as a conclusive (mandatory) presumption if introduced in a criminal action. Accordingly, the *per se* rule should not operate in criminal actions as a conclusive presumption. Rather, the *per se* rule should operate as a permissive presumption in that context.

A permissive presumption allows but does not require the jury to infer the elemental fact upon proof of the basic facts. It does not relieve the government of its burden of persuasion because the government still must convince the jury that the suggested conclusion should be inferred

104. County Court v. Allen, 442 U.S. 140, 157-160 (1979) (citations and footnotes omitted).

105. *Id.* at 160.

106. *Id.* at 161.

107. *Id.* at 162.

based on the predicate facts proved. The use of a permissive presumption is constitutional so long as there is a “rational connection” between the predicate and presumed facts. . . .¹⁰⁸

The establishment of a general *per se* rule in the proposed guidance (and its operation as a permissive, but non-rebuttable, presumption in the hands of the trier of fact in a criminal action) offers a strong, clear message to transaction planners: proceed very cautiously, if at all, in buying, selling, or selectively disclosing.

B. Failed Merger Discussions

The second exemplar factual context presented in the Initial Materiality Article involves open-market purchases of shares by a public company issuer’s directors five to six months after the issuer’s rejection of a series of undisclosed acquisition proposals at premium prices. Within one month after the directors’ share acquisitions, the putative acquirer discloses the earlier acquisition offers (in turn, driving up the market price of the issuer’s stock) and makes a successful cash tender offer to acquire the issuer at a significant premium to the prices paid by the directors.¹⁰⁹ The insider trading question in these circumstances emanates from a concern that the directors may have possessed material nonpublic information—knowledge of the existence and terms of the earlier acquisition proposals—when they bought their shares from sellers in the public market that had no knowledge of those acquisition proposals.

As with the first exemplar factual context, the second exemplar factual context does not admit to a simple application of existing formulations of the materiality standard. Among the difficulties are determining whether the specialized “probability versus magnitude” balancing test announced in *Basic v. Levinson* is applicable on these facts and deciding when, if ever, nonpublic information regarding acquisition proposals is so distant in time that it is immaterial as a matter of law. The materiality analysis and the application of the suggested approach to determining

108. *Hill v. Maloney*, 927 F.2d 646, 649 (1st Cir. 1990); *see also* *Norvell v. Miller*, 476 U.S. 1126, 1127–28 (1986).

109. *See* Heminway, *supra* note 43, at 1146–48; *see also* Evelyn M. Rusli, *After Deal Talks Sputter, Alibaba and Yahoo Said to Meet Again*, N.Y. TIMES DEALBOOK, March 20, 2012, <http://dealbook.nytimes.com/2012/03/20/after-deal-talks-sputter-alibaba-and-yahoo-meet-again/> (describing recent deal talks involving similar facts).

materiality guidance in this area led to a preliminary conclusion that

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).¹¹⁰

This suggested guidance, in the form proposed in the Initial Materiality Article, is incomplete because the term “acquisition proposal” is undefined and because the proposed guidance fails to choose between the potentially applicable three-month and six-month periods as the tipping point between *per se* materiality and presumed materiality.¹¹¹ Moreover, rulemaking since the publication of the Initial Materiality Article may call into question the two-year period suggested in the proposed guidance; accordingly, this author revisited the presumption of immateriality that attaches after two years.¹¹² Finally, the guidance proposed in the Initial Materiality Article leaves open the referenced lists of applicable rebuttal factors for the presumptions, the applicable standards of proof on rebuttal of the presumptions, and the procedural effects of a rebuttal of the presumptions that satisfies the applicable standards of proof.¹¹³ These items are addressed in the remainder of this Part.

1. Defining “Acquisition Proposal”

The suggested guidance in the Initial Materiality Article addresses, through alternating presumptions, the decreased probability that an acquisition of the target actually will occur

110. Heminway, *supra* note 43, at 1211.

111. See *infra* Parts II.B.1 & II.B.2.

112. See *infra* Part II.B.3.

113. See *infra* Parts II.B.4 & II.B.5.

following earlier, spurned acquisition proposals. Under the *Basic v. Levinson* "probability versus magnitude" formulation of the materiality standard,¹¹⁴ as the probability of occurrence of a specific contingent or speculative event decreases, the obligation to disclose present facts relating to that event will decrease. But at all steps along the way, the probability of the future event occurring is weighed against the significance of the event. In defining "acquisition proposal," the guidance instructs transaction planners and others in assessing the significance of the future transaction for the purpose of assessing its magnitude.

The *Basic* Court reminds us that mergers in which a target corporation is not the survivor are important transactions to the target because the transaction terminates the target's corporate existence.¹¹⁵ But mergers also may be important to the survivor as well as the target, and other types of transactions (including acquisitions) may, depending on the key terms of the transaction (e.g., whether all or a significant part of the corporation is affected, the proposed pricing of the transaction as compared to prevailing and historical market prices, and other transaction terms), be important to an issuer or have an impact on the total mix of information available to those trading in the issuer's stock at any given time.¹¹⁶ So, the "acquisition proposal" definition must encompass both the type of transaction and its basic terms: the object of acquisition, price, type of consideration, availability of consideration (financing for cash or debt, authorized shares for equity), etc.

The "acquisition proposal" definition also must describe the stage of the interactions between the parties. The *Basic* case itself and the failed merger discussions example used in the Initial Materiality Article both address a pre-consensus stage in the discussions of a business combination transaction.¹¹⁷ But there can be many pre-consensus phases of a transaction, each having a different relevance.¹¹⁸ The definition must differentiate among them as part of the materiality assessment.

114. See *Basic Inc. v. Levinson*, 485 U.S. 224, 238-39 (1988); Heminway, *supra* note 43, at 1163-64.

115. *Basic*, 485 U.S. at 238 (citing *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976)).

116. See *id.* at 239 (advising attention to "such facts as the size of the two corporate entities and of the potential premiums over market value.").

117. See *id.* ("No particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material.").

118. See generally *In re George C. Kern, Jr.*, Admin. Proc. File No. 3-6869, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,142 (June 29, 1987) (in

Accordingly, it is important to define the concept of an “acquisition proposal” so that corporations and their insiders know when and what to disclose, and to do that, the definition must be broad. Current mandatory disclosure rules again provide assistance and support in constructing the definition. Existing line-item disclosure rules require disclosure of various abandoned and ongoing change of control and business combination transactions in connection with purchases and sales of securities (the same circumstances under which Rule 10b-5 is operative). For example, an issuer engaging in an issuer tender offer must

describe any plans, proposals or negotiations that relate to or would result in . . . any extraordinary transaction, such as a merger, reorganization or liquidation, involving the subject company or any of its subsidiaries; [or] . . . any purchase, sale or transfer of a material amount of assets of the subject company or any of its subsidiaries.¹¹⁹

Similarly, a third-party tender offeror must 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) merger; (2) consolidation; (3) acquisition; (4) tender offer for or other acquisition of any class of the subject company’s securities; (5) election of the subject company’s directors; or (6) sale or other transfer of a material amount of assets of the subject company.¹²⁰

Contracts—especially merger agreements—also circumscribe acquisition proposals for the purpose of identifying the obligations, rights, and remedies of the parties to the agreement in the event that an alternative transaction is presented to one of the parties after the contract is signed and before the closing has occurred. Two commentators described a provision of this kind in a particular merger agreement (the “Stone-EPL Agreement”).

which the difference between “discussions” and “negotiations” was important in determining disclosure obligations); *see also* 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, 224–25, 227 (1993).

119. 17 C.F.R. § 229.1006(c)(1)–(2) (2012) (referenced in Item 6 of Schedule TO).

120. 17 C.F.R. § 229.1005(b) (incorporated into Item 5 of Schedule TO).

The Stone-EPL Agreement defined third-party acquisition proposal as “an inquiry, offer or proposal” . . . in which the third party would acquire 30% or more of EPL.”¹²¹

Contract definitions like this one abound in merger and acquisition agreements and take various forms. For example, a recent merger agreement that used the term (as it commonly is used) in no-shop, non-solicitation, and change of recommendation provisions defined the term this way:

An “Acquisition Proposal” shall mean any proposal or offer . . . for (i) a merger, reorganization, share exchange, consolidation, business combination, joint venture, partnership, recapitalization, dissolution, liquidation or similar transaction involving Company and/or any Subsidiary or Subsidiaries of the Company whose business or businesses constitute twenty-five percent (25%) or more of the assets, revenues or earnings of Company and its Subsidiaries, taken as a whole, (ii) an acquisition of assets of Company and/or its Subsidiaries equal to twenty-five percent (25%) or more of the consolidated assets of Company and its Subsidiaries or to which twenty-five percent (25%) or more of Company’s revenues or earnings on a consolidated basis are attributable (iii) an acquisition of 25% or more of the outstanding Company Common Stock, or (iv) a tender offer or exchange offer that, if consummated, would result in any person or “group” (as defined under Rule 13(d) of the Exchange Act) beneficially owning 25% or more of the outstanding Company Common Stock.¹²²

Another recent merger agreement took a different approach, separating the acquisition proposal definition from a definition of an acquisition transaction.

... “Acquisition Proposal” shall mean any offer or proposal (other than an offer or proposal made or submitted by Parent or any of its Subsidiaries) contemplating or otherwise relating to any Acquisition Transaction.

121. Amy Y. Yeung & Charles B. Vincent, *Delaware’s “No-Go” Treatment of No-Talk Provisions: Deal-Protection Devices after Omnicare*, 33 DEL. J. CORP. L. 311, 317 (2008).

122. Agreement and Plan of Merger, Parlux Fragrances, Inc., Perfumania Holdings, Inc., and PFI Merger Corp., December 23, 2011, § 5.3(i), available at http://www.sec.gov/Archives/edgar/data/880460/000088046011000020/ex21the_mergeragreement.htm.

... “Acquisition Transaction” shall mean any transaction or series of transactions (other than the Merger) involving:

- (a) any merger, consolidation, amalgamation, share exchange, business combination, joint venture, issuance of securities, acquisition of securities, reorganization, recapitalization, tender offer, exchange offer or other similar transaction: (i) in which a Person or “group” (as defined in the Exchange Act and the rules thereunder) of Persons directly or indirectly acquires beneficial or record ownership of securities representing 20% or more of the outstanding securities of any class (or instruments convertible into or exercisable or exchangeable for 20% or more of any such class) of the Company Common Stock; or (ii) in which the Company issues securities representing 20% or more of the outstanding securities of the Company (or instruments convertible into or exercisable or exchangeable for 20% or more of any such class);
- (b) any sale, exchange, transfer, acquisition or disposition of the equity securities of any business or businesses that constitute or account for 20% or more of the consolidated net revenues, consolidated net income or consolidated assets of the Company;
- (c) any sale, lease, exchange, transfer, license, sublicense, acquisition or disposition of the assets of any business or businesses that constitute or account for 20% or more of the consolidated net revenues, consolidated net income or consolidated assets of the Company; or
- (d) any liquidation or dissolution of the Company.¹²³

A combination of the ideas in the two different tender offer disclosures and the contract-based definitions, as well as common legal and practical knowledge, creates a comprehensive definition of “acquisition proposal” for use in materiality guidance in this area. An acquisition proposal exists with respect to a particular issuer when there are plans, proposals, negotiations, transactions, or similar contacts between the issuer and an affiliated or unaffiliated third party concerning any:

- election of the issuer’s directors;
- dissolution or liquidation of the issuer;

123. Agreement and Plan of Merger, Ebay Inc., Gibraltar Acquisition Corp., and GSI Commerce, Inc., March 27, 2011, at Exhibit A, *available at* <http://www.sec.gov/Archives/edgar/data/1065088/000119312511082907/dex21.htm>.

- merger, consolidation, statutory share exchange,¹²⁴ amalgamation, tender offer (or other share purchase), exchange offer, acquisition of assets, other business combination, recapitalization, reorganization, joint venture, partnership, or similar transaction that results in the issuance, conversion, or exchange of a significant percentage of the outstanding securities of any class of the issuer's securities or that impacts a significant percentage of the assets, revenues, or earnings of the issuer and its subsidiaries (if any), taken as a whole;
- tender offer for or other acquisition of a significant percentage of any class of the issuer's securities by the third party; or
- sale, exchange, transfer, license, sublicense, divestiture, or other disposition of a significant percentage of assets of the issuer.

Significant percentage may be defined as a specific percentage (e.g., 20% or 25%, as it is in the merger agreement example) or it may be left undefined (providing less definitive guidance to the putative actors).

Given the *per se* materiality component of the recommended materiality guidance, the word "inquiry" was omitted from the definition because its use would cause a mere inquiry about a transaction—regardless of its magnitude to the issuer—to be material under the *per se* part of the proposed guidance. That result would appear to disrespect the Court's guidance on balancing probabilities and magnitudes in *Basic*¹²⁵ (since a mere inquiry about a transaction indicates a low probability that the transaction will occur) and would be unduly burdensome for transaction planners. The word "material" as used in other definitions also was omitted in favor of other methods of indicating significance. This was done to avoid using the concept of materiality to define materiality in the broader context.

2. *Per se* Materiality Period

Based on current trends in U.S. securities regulation, the applicable *per se* materiality period should be six months. The Initial Materiality Article noted two touchstones for the three-month or six-month period separating *per se* materiality from

124. This business combination transaction is available in states adopting the Revised Model Business Corporation Act. See MODEL BUS. CORP. ACT § 11.03 (2002).

125. See *supra* text accompanying notes 40–41.

presumed materiality: the three-month affiliate rule then included in Rule 144(k) under the 1933 Act¹²⁶ and the six-month strict liability profit disgorgement rule of Section 16(b) of the 1934 Act.¹²⁷ The more conservative six-month period is more closely tied to the policy underpinnings of U.S. insider trading regulation.

Since the Initial Materiality Article was published, Rule 144 has been amended (in 2007, effective in 2008) to delete former Rule 144(k) and replace it with three-month requirements in Rule 144(b)(1)(i) and (ii).¹²⁸ This requirement, together with the 90-day affiliate references in Rule 144(b)(2) relating to the ability of affiliates to be deemed underwriters and create underwriter status in others,¹²⁹ indicates that periods of approximately three months may be appropriate benchmarks for SEC and public concerns about the use of nonpublic information by affiliates in the public markets. It appears the SEC has determined that after three months, the salience of an affiliate's information has dissipated to the point that all relevant constituencies should be content to treat the affiliate as if he or she were a non-affiliate.

The six-month short-swing-profit disgorgement provision remains the same as it was when the Initial Materiality Article was published. This time period, which is part of an insider trading prohibition, may be seen as more directly applicable to materiality analyses than the three-month affiliate rules in Rule 144 under the 1933 Act. Although the six-month period used in Section 16(b) is widely criticized in the strict liability context of that rule, the period does have some basis as a measuring device in insider trading deterrence.¹³⁰ "Congress apparently believed that the six-

126. Heminway, *supra* note 43, at 1210.

127. *Id.* at 1210–11.

128. 17 C.F.R. § 230.144(b)(1) (2012); *see also* U.S. SEC. & EXCH. COMM'N, Revisions to Rules 144 and 145, Securities Act Release No. 8869, 92 SEC Docket 110 (Dec. 6, 2007), *available at* <http://www.sec.gov/rules/final/2007/33-8869.pdf> [hereinafter Rule 144 Release].

129. 17 C.F.R. § 230.144(b)(2).

130. *See generally* Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088 (1994) (asserting that the six-month period in Section 16(b) discourages insider trading by forcing insiders to hold onto securities under circumstances in which they might otherwise trade sooner). Professor Jesse Fried notes that

Section 16(b) . . . is still believed to serve three useful purposes: (1) it reduces insiders' ability to profit from short-term stock price fluctuations, better enabling them to focus their attention on the long-term performance of the firm; (2) it makes it more difficult for insiders to exploit Rule 10b-5's limitations by unfairly using sub-material inside information; and (3) it reduces insiders' incentives to manipulate the information transmitted by the corporation in order to make short-term trading profits.

month period would capture virtually all transactions in which there might be an opportunity to profit from the use of inside information."¹³¹ Moreover, director and officer insiders under Section 16(b), unlike affiliates under Rule 144, remain restricted in their trading for up to six months after their insider status terminates (until six months after an opposite trade made before termination of director or officer status).¹³² These six-month periods evidence decreased concern on the part of Congress and the SEC that information gained from privileged positions is important after six-months has passed.

Six-month rules of thumb in U.S. securities regulation are prevalent (though not always fully explainable or defensible). The 2007 amendments to Rule 144 shortened the holding period for resales of restricted securities of public company issuers (reporting issuers, for purposes of the 1934 Act) to as little as six months, as long as certain other requirements, including the public information requirements in Rule 144(c)(1), have been met.¹³³ Also, certain offers or sales of securities made within six months of each other are presumptively integrated for purposes of exemptions and safe harbors from registration under Rule 147,¹³⁴ Regulation D,¹³⁵ and Regulation A.¹³⁶ Although these rules have little to do with the relative staleness of information acquired by corporate affiliates or insiders, each is a rule that engages temporal proximity to identify (among other things) the proper mix of available information that should be considered when determining the required disclosure of a particular matter (here, an offering of

Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through PreTrading Disclosure*, 71 S. CAL. L. REV. 303, 362 (1998).

131. Michael H. Dessent, *Weapons to Fight Insider Trading in the 21st Century: A Call for the Repeal of Section 16(b)*, 33 AKRON L. REV. 481, 497 (2000) (footnote omitted); see also Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1111 (1985) ("The legislative history emphasized the need to renew investors confidence in the exchange markets by deterring profitable short swing trading by insiders or large stockholders presumed to have access to inside information.").

132. See 17 C.F.R. § 240.16a-2(b)(1) ("A transaction . . . following the cessation of director or officer status shall be subject to section 16 of the Act only if: (1) Executed 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. . . .").

133. 17 C.F.R. § 230.144(d)(1)(i).

134. 17 C.F.R. § 230.147(b)(2) (referencing Preliminary Note 3).

135. 17 C.F.R. § 230.502(a).

136. 17 C.F.R. § 230.251(c)(2)(v).

securities). The materiality component of U.S. insider trading regulation functions much the same way—as a filtering device for information required to be disclosed before an insider may engage in a trading transaction.¹³⁷

3. Two-year Presumptive Immateriality Period

The Initial Materiality Article identifies a number of bases for the conclusion that disclosures relating to prior acquisition proposals become stale under mandatory disclosure rules after two years.¹³⁸ These bases remain firm almost ten years later.

However, advances in information technology continue to shorten time frames relevant to mandatory disclosure. In particular, as noted with respect to the three-month-versus-six-month analysis in Part II.B.2 above, required holding periods under Rule 144 have been getting progressively shorter. Specifically, the holding period for restricted securities held by non-affiliates was reduced from two years to one year.¹³⁹ Rule 144 provides that specified sellers of securities will not be deemed to be underwriters of those securities for purposes of the exemption under Section 4(1) of the 1933 Act,¹⁴⁰ a safe harbor from underwriter status. This provision relies on, among other things, the length of time that a person holds securities acquired from the issuer or one of its affiliates—i.e., the length of time that the security has been held by a non-insider. Accordingly, the shorter time periods under Rule 144 may indicate that the two-year rules of thumb relied upon in the Initial Materiality Article's analysis also should be shortened.

137. See Heminway, *supra* note 43, at 1149–50 (analogizing materiality to the Hogwarts Sorting Hat from the Harry Potter books).

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. 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. Either the fact is material and must be disclosed, or it is not material and need not be disclosed. 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.

Id. at 1149 (footnotes omitted).

138. *Id.* at 1206–08.

139. See 17 C.F.R. § 230.144(b)(1); see also Rule 144 Release, *supra* note 128.

140. 15 U.S.C. 78d(1) (2006).

In a recent action asserting a violation of Section 5 of the 1933 Act, a defendant made a similar argument that did not prevail.¹⁴¹ The court noted, among other things, that Rule 144 provides “safeguards for investors” that do not exist outside its purview that contribute to the rationale for a shorter period.¹⁴² Given this result, even taking into account that rebuttal factors may act as important investor safeguards, this author is hesitant to propose varying the two-year period suggested in the Initial Materiality Article. Yet, two years after withdrawal, rejection, or abandonment of an acquisition proposal is a long time. Are there any reasons why the fact of an acquisition proposal would be material after two years (including at least one full audit cycle)? This author can conceive of only a few circumstances, all of which are outlined in Part II.B.4 below. Materiality would be rare in these circumstances.

Given the narrow scope of potential materiality of an acquisition proposal two years after its withdrawal, rejection, or abandonment, it seems appropriate to consider whether a *per se* immateriality rule for the period beginning two years after the withdrawal, rejection, or abandonment of an acquisition proposal is more appropriate than a presumption of immateriality. Although this idea is appealingly simple, this author has two principal reservations about proposing this change. First, guidance that institutes *per se* immateriality discourages the kind of rigorous thinking about the market-importance of information that the materiality requirement encourages. Instead, a *per se* immateriality rule would act as a black-line materiality rule that allows bad actors a means of constructing avenues for opportunistic, self-serving behaviors. Second, as a related, more specific point, I am concerned that the notion of *per se* immateriality in insider trading disclosure guidance might be inappropriately imported to other disclosure contexts in which fraud protection in general (and materiality as an element of a fraud claim in particular) provides an important check on and enhancement to mandatory disclosure (in the form of either line-item or gap-filling rules).¹⁴³ For example, Rule 10b-5 compels disclosure of material facts “necessary in order to make the statements made, in the light of the

141. *S.E.C v. Big Apple Consulting USA, Inc.*, No. 6:09-CV-1963-ORL-28GJK, 2011 WL 3753581, at *7–8 (M.D. Fla. Aug. 25, 2011).

142. *Id.* at *8.

143. See Heminway, *supra* note 43, n.240 (describing the over-inclusiveness and under-inclusiveness of mandatory disclosure rules, including line-item and gap-filling rules).

circumstances under which they were made, not misleading.”¹⁴⁴ Accordingly, the proposed guidance does not include a *per se* immateriality rule for the period beginning two years after the withdrawal, rejection, or abandonment of an acquisition proposal.

4. Rebuttal Factors

As noted earlier in this Part II.B,¹⁴⁵ the materiality guidance on failed merger discussions proposed in the Initial Materiality Article includes shifting presumptions as to materiality (starting six months after withdrawal, rejection, or abandonment of the acquisition proposal) and immateriality (starting two years after withdrawal, rejection, or abandonment of the acquisition proposal).¹⁴⁶ As was true for the presumptions suggested for use in the proposed materiality guidance on improper balance sheet accounting, the presumptions suggested regarding failed merger discussions are rebuttable based on evidence cutting against the presumed conclusion. Accordingly, rebuttal factors relating to the presumption that facts relating to an acquisition proposal are material between six months and two years after the withdrawal, rejection, or abandonment of that acquisition proposal include the following facts and circumstances:

- the offeror made a single acquisition proposal that never matured into discussions or negotiations;
- the issuer has had no contact with the offeror since the withdrawal, rejection, or abandonment of the proposal;
- based on publicly available information, the transaction that is the subject of the proposal is no longer possible;
- publicly available market-based or third-party valuations of the issuer (including the issuer’s per-share or aggregate market capitalization) exceed the value represented by the withdrawn, rejected, or abandoned offer and the issuer is not otherwise a prime target for a third-party acquisition; and

144. 17 C.F.R. § 240.10b-5 (2012). *See also* Heminway, *supra* note 43, at 1170–71 (“[I]n requiring the complete and accurate disclosure of material facts in specific contexts, anti-fraud rules act as gap-filling disclosure rules.”).

145. *See supra* Parts II.B.2 & II.B.3.

146. The author notes here, with respect to the two parenthetical expressions in this sentence, that it may not be easy to determine, in some factual circumstances, when an acquisition proposal is withdrawn, rejected, or abandoned. The guidance proposed here and in the Initial Materiality Article is not intended to create bright line rules that create absolute certainty for the parties on all possible facts. Rather, they are designed to diminish uncertainty to transaction participants to achieve greater efficiencies.

- the issuer is not in the market for a transaction substantially similar to, or with attributes substantially similar to, the transaction that was the subject of the acquisition proposal.

Factors rebutting the presumption that facts relating to an acquisition proposal are immaterial when two years have passed since the withdrawal, rejection, or abandonment of the proposal include the converse of those listed for presumed materiality. A withdrawn, rejected, or abandoned acquisition proposal may be material more than two years later if

- the acquisition proposal had been particularly well-developed before its withdrawal, rejection, or abandonment;
- there has been continued contact between the parties since the withdrawal, rejection, or abandonment of the acquisition proposal;
- the transaction that was the subject of the acquisition proposal is still possible;
- the acquisition proposal valuation of the target exceeds other available valuations; or
- the issuer is in the market for a transaction substantially similar to, or with attributes substantially similar to, the transaction that was the subject of the acquisition proposal, especially if the non-issuer party is the only (or one of a few) possible transaction partners.

Arguably, materiality would be rare but still possible in these circumstances. The last rebuttal factor is the most powerful of those listed and should carry the most weight in decision-making. In some cases, however, the total mix of information in the marketplace may include substantially all of the information that is important in making an investment decision. That assessment would need to be made at the time of the proposed purchase or sale or information transfer that could give rise to insider trading liability. Said differently, under many circumstances, it would be improbable that there would be a substantial likelihood that the reasonable investor would find that a failure to disclose the acquisition proposal would be important or would significantly alter the total mix of available information.¹⁴⁷ The proposed guidance here does not change those general touchstones of materiality law in the insider trading context. It merely affords

147. See generally *Basic Inc. v. Levinson*, 485 U.S. 224, 224 (1988) (citing *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976), for this “total mix formulation” of the materiality standard).

better *ex ante* certainty for transaction planners and narrows *ex post* enforcement discretion.

5. Standard of Proof and Procedural Effects

The standard of proof applicable to rebuttals of the presumptions and the effect of successful rebuttals is no different for the failed merger discussions example than it is for the improper balance sheet accounting example in civil actions.¹⁴⁸ A rebutting party should have to establish the rebuttal factors in a civil case by a preponderance of the evidence. As described above, this means that the establishment of any of the rebuttal factors by a preponderance of the evidence leaves the case to a judicial determination at trial based on all available evidence appropriately brought before the court, and the inability of a party to assert in good faith the existence of any rebuttal factor enables a trier of fact to find facts consistent with the presumption.

However, the proposed guidance for failed merger discussions, like the improper balance sheet accounting guidance, includes a conclusive (mandatory) presumption: the *per se* materiality rule for an acquisition proposal during the time it is actively being considered and for six months after it is withdrawn, rejected, or abandoned. Handling this as a permissive (non-rebuttable) presumption, as proffered for the *per se* materiality rule for improper balance sheet accounting,¹⁴⁹ should obviate constitutional concerns while at the same time powerfully guiding the actions of transaction planners and other actors who would turn to the proposed materiality guidance for advice and assistance in making materiality determinations in the insider trading context.

III. CHOOSING THE RIGHT RULEMAKING INSTITUTION

Having fleshed out the substance of proposed materiality guidance for circumstances involving both improper balance sheet accounting and failed merger discussions, the article now proceeds to determine the rulemaking institution that should adopt this guidance. Because the guidance is a federal corporate governance initiative, three choices emerge: the federal courts, the U.S. Congress, and the SEC. As previously noted, the Institutional Choice Article provides a framework for making this kind of comparative institutional choice.¹⁵⁰ The discussion and analysis in

148. See *supra* Part II.B.2.

149. See *supra* text accompanying note 108.

150. See *supra* text accompanying note 64.

this Part employ that framework and provide a basis for concluding that the SEC is the most appropriate institutional body to adopt the proposed materiality guidance. Because application of the framework shows that the SEC may be the best institution for adopting the proposed materiality guidance, this Part concludes with a brief discussion of the political economy of SEC rulemaking in the current environment.

A. Comparative Institutional Analysis

In the next few pages, this Part provides a comparative analysis of the potential rulemaking institutions for issuing the proposed insider trading materiality guidance. The analysis proceeds in four steps, representing the four factors in the analytical framework: comparative institutional capacity, comparative institutional competence, comparative institutional impartiality, and comparative legal transition costs.¹⁵¹

1. Comparative Institutional Capacity

The federal courts, Congress, and the SEC all currently share capacity for insider trading regulation in the United States. The courts have exercised broad jurisdiction over insider trading actions under Section 10(b) and Rule 10b-5.¹⁵² Congressional power to regulate insider trading under the interstate commerce clause is similarly broad.¹⁵³ In principle part, however, the U.S. Congress has delegated its power to the SEC in Section 10(b),¹⁵⁴

151. See Heminway, *supra* note 64.

152. See, e.g., John I. McMahon, Jr., Note, *A Statutory Definition of Insider Trading: The Need to Codify the Misappropriation Theory*, 13 DEL. J. CORP. L. 985, 990 (1988) (referencing “the power of the courts, depending on their particular interpretation of Rule 10b-5, to limit or expand the SEC’s ability to successfully prosecute insider traders and protect the financial integrity of the securities market”); Thomas C. Mira, Comment, *The Measure of Disgorgement in SEC Enforcement Actions Against Inside Traders Under Rule 10b-5*, 34 CATH. U. L. REV. 445, 456 (1985) (“The most widely used enforcement tool in insider trading cases has been section 21(d) of the 1934 Act, which provides the SEC with authority to bring suit in federal courts to enjoin violations of the securities laws.”).

153. See generally Heminway, *supra* note 64, at 248–52 (describing congressional power to regulate matters of corporate governance).

154. 15 U.S.C. § 78j(b) (2006) (prohibiting generally the use or employment in connection with securities trading of “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*” (emphasis added)).

the Insider Trading Sanctions Act of 1984,¹⁵⁵ and the Insider Trading and Securities Fraud Enforcement Act of 1988,¹⁵⁶ and by inaction. The SEC has exercised this authority to propose and adopt numerous regulations under Section 10(b), including Rules 10b-5, 10b5-1, and 10b5-2,¹⁵⁷ all of which pertain to insider trading. In sum, although all three institutions have capacity to regulate the elements of insider trading, including materiality, Congress has (1) expressly delegated regulatory authority over insider trading to the SEC and the federal courts in various legislative pronouncements and (2) has otherwise implicitly left the heavy lifting in U.S. insider trading regulation to the SEC and the courts.¹⁵⁸

155. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified in scattered sections of 15 U.S.C.); *see also* Liu Duan, Comment, *The Ongoing Battle Against Insider Trading: A Comparison of Chinese and U.S. Law and Comments on How China Should Improve Its Insider Trading Law Enforcement Regime*, 12 DUQ. BUS. L.J. 129, 137 (2009) (“[T]he U.S. Congress enacted several supplementary rules including the Insider Trading Sanctions Act of 1984 (ITSA), which authorizes the SEC to ask the courts to impose penalties on illegal traders and upon those who tip nonpublic information to third parties” (footnote omitted)).

156. Insider Trading & Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified in scattered sections of 15 U.S.C.); *see also* Liu Duan, *supra* note 155, at 137 noting that “the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), . . . gives the SEC authorization to ask courts to impose a civil penalty of three times the profit from illegal insider trading.” (footnotes omitted)).

157. 17 C.F.R. § 240.10b-5 (2012); 17 C.F.R. § 240.10b5-1; 17 C.F.R. § 240.10b5-2.

158. *See* United States v. Chestman, 947 F.2d 551, 573 (2d Cir. 1991) (Winter, J., dissenting) (“Even the most fervent opponents of insider trading must concede that the language of Section 10(b) and Rule 10b-5 is at best a general authorization to the SEC and to the courts to fashion rules founded largely on those tribunals’ judgments as to why insider trading is or is not fraudulent, deceptive or manipulative.”); Shalini M. Aggarwal, *From The Individual to the Institution: The SEC’s Evolving Strategy for Regulating the Capital Markets*, 2003 COLUM. BUS. L. REV. 581, 590 (“Insider trading law has primarily developed through enforcement rulemaking and is prosecuted through recourse to the antifraud provisions of the federal securities laws.” (footnotes omitted)); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79, 83 (1987) (“Notwithstanding the apparent difficulties with grounding an administrative and judicial doctrine of insider trading regulation on authorities as ill-suited as Section 10b and Rule 10b-5, the lower courts and the SEC proceeded to do just that.”); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 125 (1988) (“An acorn of vague language in the 1934 Act gradually became the sapling of equally vague but broader language in SEC Rule 10b-5 and finally a forest of federal anti-fraud law, with a large grove of insider trading law. This process happened partly because of judicial and bureaucratic incentives and politically

2. Comparative Institutional Capacity

Typically, the judiciary does not have much expertise in securities regulation.¹⁵⁹ However, because of the significant judicial decision-making that has constructed and refined insider trading doctrine in the United States, the federal courts are well-versed in the law defining and interpreting materiality in the insider trading context. Yet, despite this substantive expertise, courts are ill equipped, as a general matter, to assemble the information and resources necessary to engage in comprehensive rulemaking in an area like materiality. A court depends on having a case before it that allows it to rule on a particular matter; the manner of regulation of the judiciary is, therefore, by its nature, unpredictable and incremental rather than regular and comprehensive.¹⁶⁰ In addition, the judiciary is independent. The activities of individual judges across the U.S. District Courts and the Circuit Courts of Appeal are not formally coordinated, except through *stare decisis*, when applicable.¹⁶¹ It would be very difficult for the federal courts, in spite of their expertise in materiality standards in insider trading, to fashion comprehensive materiality guidance with alternating presumptions over a range of facts.

Similarly, the structure and expertise of the U.S. Congress are not optimal for the task of adopting and implementing materiality guidance in the context of insider trading. Structurally, Congress is better equipped to handle the comprehensive rulemaking represented in the proposed materiality guidance.¹⁶² A bill defining materiality in the context of insider trading could be introduced, an agenda for vetting the bill could be established, and congressional committees could work through the language.¹⁶³ However, Congress has judiciously avoided defining and otherwise legislating in the area of insider trading,¹⁶⁴ creating doubt about its

powerful groups, and partly because the courts had developed no clear guidelines that might constrain the growth of the law.”).

159. See, e.g., Peter G. Morrissey, Note, *Regulating Risk in Financial Markets: Private Insurance for Public Funds*, 69 S. CAL. L. REV. 1163, 1174 (1996) (“Judges rarely have a detailed background in securities trading and financial market innovation.”).

160. See Heminway, *supra* note 64, at 292–94.

161. See *id.* at 295 (“[N]ational uniformity may be difficult to achieve as across all of the federal districts and circuits.”).

162. See *id.* at 266.

163. See *id.* at 265–66.

164. See, e.g., 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, 168 (1995) (“Congress has refused to define

capacity and willingness to take on the substantive details of insider trading regulation (and also raising uncertainty about where the definition of materiality for insider trading purposes might fit within the existing statutory framework). The level of detail in the proposed materiality guidance does not lend itself well to the political, partisan, public debate that characterizes the U.S. Congress. The proposed guidance was constructed through a synthesis and careful balancing of principles from decisional law and other resources. This is not the kind of job that Congress does efficiently or effectively.

In addition, although the U.S. Congress has significant experience and aptitude in drafting statutory definitions, the definition of materiality in insider trading regulation is a highly specialized, judicially constructed definition that operates in a rich, detailed regulatory construct. This is not, in general, the type of matter over which Congress would have institutional expertise.¹⁶⁵

“Of our . . . branches of government, the specialized executive regulatory agencies, such as the Securities and Exchange

insider trading”); Richard W. Painter, *Insider Trading and the Stock Market Thirty Years Later*, 50 CASE W. RES. L. REV. 305, 310 (1999) (“[T]his commentator remains concerned that Congress has yet to enact a statutory definition of illegal insider trading”); A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 934 (2003) (“Congress was unable to agree on a definition of insider trading.”); Steven Thel, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 FORDHAM L. REV. 1183, 1198 (1995) (“Congress has refrained from defining the law’s parameters. Instead, it has left the formulation of the private liability regime to the courts.”); Gregory G. Faragasso, Note, *A Policy Analysis Of New York State’s Security Takeover Disclosure Act*, 53 BROOK. L. REV. 1117, 1142 n.140 (1988) (“The Securities Industry Association, along with a number of lawyers, Wall Street executives, and lawmakers, have urged Congress to adopt a statutory definition of insider trading.”); Morrissey, *supra* note 159, at 1174–75 (“Congress recognizes that it lacks much of the expertise required for detailed regulation of the securities industry.”).

165. See Heminway, *supra* note 64, at 274 (“[C]ommentators acknowledge that expertise on highly specialized matters of substantive law and regulation (including corporate and securities law) generally are outside the actual and potential expertise of legislatures, because of the significant experience, time, and other resources needed to develop that expertise.”); Note, *The Case for Federal Threats in Corporate Governance*, 118 HARV. L. REV. 2726, 2739 (2005) (“Congress lacks the requisite capability and information to make efficient corporate law decisions.”); Mary Buffington, Comment, *Separation of Powers and the Independent Governmental Entity After Mistretta v. United States*, 50 LA. L. REV. 117, 119–120 (1989) (“Congress does not have the necessary expertise and time to devote to specialized areas of regulation. . . Congress delegates power to oversee and monitor specialized areas requiring expertise, such as securities regulation.” (footnotes omitted)).

Commission, . . . have more technical capability than the courts or legislature.”¹⁶⁶ The SEC has the best structural and substantive competence for issuing materiality guidance in the context of insider trading.

Judgments concerning what disclosure, if any, . . . should be mandated are best made at this stage of the science, not by a court under a very general materiality standard, but by an agency with finance expertise. An administrative agency – the Securities and Exchange Commission – has a technical staff, is able to hold public hearings, and can, thus, receive wide and expert input, and can specify forms of disclosure, if appropriate. It can propose rules for comment and can easily amend rules that do not work well in practice.¹⁶⁷

Although the SEC’s reputation as a federal agency has been damaged by its failure to detect and prevent major instances of securities fraud (e.g., the Bernie Madoff affair) and its contributing role in the financial crisis,¹⁶⁸ the SEC has undergone significant reform efforts leading up to and in the wake of the Dodd-Frank Act.¹⁶⁹ The Commission is well positioned to deploy its reorganized expert staff members to evaluate, enhance, and introduce the materiality guidance in a deliberate, accessible manner through the appropriate agency channels.¹⁷⁰

166. Morrissey, *supra* note 159, at 1175.

167. *Lewis v. Vogelstein*, 699 A.2d 327, 332–333 (Del. Ch. 1997).

168. Renee M. Jones, *Legitimacy and Corporate Law: The Case for Regulatory Redundancy*, 86 WASH. U. L. REV. 1273, 1309 n.159 (2009) (“The SEC’s reputation has suffered badly as a result of the financial crisis and other major scandals.”); David P. McCaffrey, *Review of the Policy Debate Over Short Sale Regulation During the Market Crisis*, 73 ALB. L. REV. 483, 518 (2010) (“[R]eports regarding Bernard Madoff’s fraud and other matters related to the financial crisis damaged the SEC’s reputation in 2008-2009, and a reputational survey in 2009 rated the SEC lowest of six federal agencies listed.”).

169. See, e.g., Joan MacLeod Heminway, *Sustaining Reform Efforts at the SEC: A Progress Report*, 30 No. 4 BANKING & FIN. SERV. POLICY REPORT 1 (2011) [hereinafter *Progress Report*]; Joan MacLeod Heminway, *Reframing and Reforming the Securities and Exchange Commission: Lessons from Literature on Change Leadership*, 55 VILL. L. REV. 627 (2010).

170. See generally Jones, *supra* note 168, at 1308–18 (assessing and praising, in relative terms, the SEC’s deliberative rulemaking process in the post-crisis era); see also Heminway, *supra* note 64, at 275–82 (raising similar points in the pre-crisis era).

3. Comparative Institutional Impartiality

The federal courts are, as a general principal, the most impartial sources of rulemaking.¹⁷¹ Congress is the most likely to be subject to influence and bias,¹⁷² and the SEC typically is more impartial than Congress but less so than the federal courts.¹⁷³ Specifically, the accessibility of Congress makes it subject to lobbying by various public interest groups.¹⁷⁴ Moreover, Congress is a highly politicized body.¹⁷⁵ These attributes have hampered various rulemaking projects in the past few years. The SEC is not, however, immune to similar charges. Interest groups, primarily those representing the securities industry, may exert powerful influence over the SEC,¹⁷⁶ and the Commissioners do split decisions on some important matters along political lines.¹⁷⁷

The proposal to issue guidance on materiality in the insider trading context recommended in this article is not a highly politicized initiative. If crafted and promoted properly, it should be received as unremarkable (given its objective of clarifying the materiality standard within the bounds of existing law and regulation) and should appeal to both business leaders and investors alike because it balances business and investor considerations through *per se* rules and presumptions derived from existing disclosure guidance. As a result, the influences to which

171. See Heminway, *supra* note 64, at 327–32.

172. See *id.* at 307–18.

173. See *id.* at 319–26.

174. See *id.* at 313–16; Nathan Alexander Sales, *Secrecy and National Security Investigations*, 58 ALA. L. REV. 811, 831 (2007) (“Familiar public choice principles instruct that, as is true any time Congress makes policy that affects industry or public interest groups, there is the possibility of capture.”).

175. See Jones, *supra* note 168, at 1302 (“[T]he partisanship and ideological rigidity that characterizes Congress in recent decades . . . creates obstacles to meaningful substantive debates. These factors limit Congress’s ability to act decisively on corporate issues except in times of crisis.”).

176. See Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 134 (2006) (“[T]he SEC may simply invoke ‘investor confidence’ without really meaning it, instead catering to the needs of powerful interest groups in the securities industry. Detailing the assumptions the SEC makes with respect to investors may help expose flaws and inconsistencies in the assumptions and regulatory regime, thereby focusing attention on the possibility of other, more public choice motives behind the SEC’s actions.”).

177. See, e.g., John Reiss & Colin Diamond, *Explanation and Practical Tips Regarding the SEC’s New Proxy Access Regime*, 14 THE M&A LAWYER 1 (Oct. 2010), available at <http://www.wsgr.com/publications/PDFSearch/mal1010.pdf>; Douglas A. McIntyre, *Goldman Sachs: SEC Commissioners Often Vote 3-2 along Party Lines*, 24/7 WALL ST., April 19, 2010, <http://247wallst.com/2010/04/19/goldman-sachs-sec-commissioners-often-vote-3-2-along-party-lines/>.

each rulemaking institution is subject and the biases exhibited by each institution are not as important in the choice of an optimal rule maker for the materiality guidance suggested in this article as other factors.

4. Comparative Legal Transition Costs

As a general matter, the costs of legal change associated with adoption of the proposed materiality guidance are positively impacted by the fact that the guidance works within existing legal and practice norms. Few costs differ as across the various possible rule makers, except that costs in certain areas will be higher for guidance issued through court opinions, because of the slow, incremental, uncontrolled fashion in which judicial rulemaking takes place.

Learning costs—the cost of learning the new rule¹⁷⁸—should be low, as a general matter, given that there is very little new substantive information in the proposed materiality guidance; the value of the guidance is in the consolidation of that information and the process for engagement with it. The purpose and effect of issuing the guidance is to clarify the application of the existing materiality standard in certain factual settings by making the process and result more clear. As a result, the guidance should predominantly make clearer and simpler what transaction planners, litigators, counsel, and others already should know—or would know after conducting targeted research—and assure greater consistency and predictability in any resulting thought processes, advice, and enforcement.

The detailed, tailored materiality guidance offered *supra* Part II is designed to minimize uncertainty costs across all institutions.¹⁷⁹ However, there will certainly be identifiable transition costs. For example, lawyers and their clients may have to give up or revise existing thought processes and systems for assessing the risks associated with purchases and sales of securities, balance sheet accounting, and acquisition proposals and establish new ones as a means of ensuring compliance with the guidance. And although “acquisition proposal” is defined in Part II,¹⁸⁰ there no doubt will be definitional and other interpretive questions that will arise with respect to that definition and other, undefined terms and concepts employed in the guidance. Also, the burden of proof and

178. See Heminway, *supra* note 64, at 334–36.

179. See *id.* at 337–41.

180. See *supra* Part II.B.1.

procedural effects components of the guidance¹⁸¹ are difficult to convey and apply, which may result in additional learning costs. It will be easier to keep the text as clear, coherent, and comprehensive as possible if the materiality guidance is issued at a single time by one rulemaking institution, i.e., the U.S. Congress or the SEC (rather than in individual cases by the federal courts). Finally, in clarifying materiality, the proposed guidance may inadvertently discourage some transactions that the rule maker did not intend to frustrate or encourage some transactions that the rule maker did not intend to promote.

There should be few development and administrative costs in implementing the proposed materiality guidance because there should be little need for new business standards and tools to assure compliance with that guidance. However, issuers will likely want to revise their securities trading compliance programs to conform to the *per se* materiality rules and presumptions of materiality and immateriality offered in the guidance. The costs of these changes will be lower for congressional and SEC rulemaking because it would be done comprehensively, all at one time (while judicial rulemaking would push toward comprehensive guidance incrementally over a period of time). In general, it is more distracting and costly to continue to adjust internal and external transaction terms and tools in stages.

Some inter-firm development and administrative costs will take time to implement even if Congress or the SEC implements the proposed materiality guidance. Merger and acquisition agreements and other transactional contracts and instruments may need to be modified to reflect the certainty and predictability introduced to transaction processes through the proposed materiality guidance. Parties will negotiate their new forms, and later regulatory actions and court opinions will validate or invalidate those forms. Yet, if the materiality guidance were to be undertaken through judicial rulemaking, this process would be slower and potentially could remain incomplete for quite a long time.

Finally, error costs likely will occur, as with any new rule. Although the substance of the proposed materiality guidance is relatively clear and carefully drawn, those who use the guidance (transaction planners, litigants, and their counsel, as well as regulators, enforcement agents, and judges) will no doubt make mistakes in its expression and application. Dispute resolution and its attendant costs then will result. These costs, like learning costs, are best avoided with careful drafting, regardless of whether that drafting is done by courts, Congress, or the SEC.

181. See *supra* Parts II.A.2 & II.B.5.

5. Resulting Comparative Institutional Choice

In sum, the SEC has capacity to issue the proposed materiality guidance, has the most favorable combined structural and substantive institutional competence, is relatively free from influence and bias in connection with materiality rulemaking, and (together with the U.S. Congress) best minimizes anticipated legal transition costs associated with the issuance of the guidance. However, given the relative structural competence and impartiality of the federal courts, they represent a viable second-choice rule maker for the materiality guidance. Although congressional rulemaking is less incremental (which would decrease costs), Congress has less expertise than the SEC and the federal courts in the area of materiality in the insider trading context. Also, Congress is a more politicized body, which may slow down the rule making process and increase costs, even though the materiality guidance is unlikely to be a partisan proposal). The SEC, therefore, is the most appropriate rulemaking institution for the materiality guidance, and the federal courts are the next-best institutional choice.

B. The Political Economy of Current SEC Rulemaking

When work on this project commenced, rulemaking under the Sarbanes-Oxley Act of 2002¹⁸² and the SEC's 2005 offering reform initiatives¹⁸³ had concluded. The SEC, under regulatory fire for much of the new millennium, was in a period of relative repose. It was seemingly a good time to suggest new rulemaking. Today is another day

Commentators on this project have argued, some of them quite persuasively, that the SEC is unlikely to engage in rulemaking in this area at this time. The SEC has been repeatedly (explicitly or implicitly, in different contexts) invited to do so, including in connection with insider trading-related rulemaking, and has declined the invitation.¹⁸⁴ Moreover, the SEC's current operations

182. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

183. Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722, 44,731 (Aug. 3, 2005). See also Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U.L. REV. 561 (2007) (describing and critiquing the SEC's 2005 offering reforms).

184. For example, in promulgating Regulation FD (an insider-trading-related rule concerning the selective disclosure of material nonpublic information to market professionals), the SEC stated:

are underfunded and understaffed, and the fulfillment of regulatory requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act (and, more recently, the Jumpstart Our Business Startups Act,¹⁸⁵ or JOBS Act, for short) is a significant ongoing burden for the agency.¹⁸⁶ The suggestion that the SEC engage in new voluntary legislative or nonlegislative rulemaking on its own motion is, indeed, likely to be unpopular at the present time.

Two other productive paths are possible. The SEC could, in lieu of rulemaking, adopt the suggested materiality guidance as a statement of internal policy for use in making enforcement decisions.

Policy statements are nonlegislative rules that tentatively indicate how agency decisionmakers will exercise a discretionary power. Such rules might, for example, isolate the factors that should be considered in making decisions, rank priorities, set tolerance levels, explain when dispensations should be granted, build flexibility into overly rigid rules, indicate what data are relevant, or

Some commenters suggested that the regulation include a bright-line standard or other limitation on what was material for purposes of Regulation FD, or identify in the regulation an exclusive list of types of information covered. 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.

See U.S. SEC’S & EXCH. COMM’N, *Selective Disclosure and Insider Trading*, Release No. 33-7881, Aug. 21, 2000, available at <http://www.sec.gov/rules/final/33-7881.htm> (footnote omitted). Rule 10b5-1 and 10b5-2, both insider trading rules, also decline to define materiality, even though each rule uses the word material. See 17 C.F.R. § 240.10b5-1 (2012) (defining when a purchase or sale constitutes trading “on the basis of” material nonpublic information in insider trading cases brought under Section 10(b) and Rule 10b-5); § 240.10b5-2 (setting forth a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading). The preliminary note to each rule specifically notes that “[t]he law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect.” *Id.*

185. H.R. 3606, 112th Congress (2012), available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

186. See Heminway, *Progress Report*, *supra* note 169, at 9–11 (regarding SEC underfunding in the wake of the Dodd-Frank Act).

otherwise narrow the available decisional referents that must be taken into account.¹⁸⁷

This approach is certain to be more palatable (even if not more popular) and, if publicly announced, could have similar positive effects not just on the exercise of enforcement discretion but also on transactional decision-making. However, this approach still requires SEC decision-making and, therefore, the expenditure of scarce agency resources. Assuming the SEC is maximizing utility, it will weigh the benefits and costs and determine whether the former justify the latter.¹⁸⁸ In fact, as a federal agency, its rulemaking is reviewed for cost-effectiveness.¹⁸⁹ This calculus may well lead the SEC to forego rulemaking activity on materiality, at least at the present time. Accordingly, as a next-best option, this article suggests that federal courts engage the type of analysis suggested here in adjudicating materiality disputes in insider trading actions involving improper balance sheet accounting and failed merger discussions as they arise.

IV. THE RESULTING MATERIALITY GUIDANCE PROPOSAL

The SEC may exercise one of several options in adopting and disseminating the proposed materiality guidance. It could, for example, propose one or more new rules (perhaps Rule 10b5-3 and Rule 10b5-4) for notice and comment under the APA.¹⁹⁰ The adoption of legislative rules through the APA notice-and-comment process is a traditional and well-used approach for the SEC. Among other things, the notice-and-comment process provides transparency and enhances legitimacy.¹⁹¹ However, this path offers disadvantages similar to those provided by an open, public congressional process (although, as an indirectly representative body, the SEC should be in a position to control the process and its outcome better than Congress). Among other things, the deliberativeness of the notice-and-comment process can be costly in terms of time and money.¹⁹² In the alternative, the SEC could issue an interpretive release or policy statement¹⁹³ because the

187. Asimow, *supra* note 18, at 386–87.

188. *See id.* at 404–05.

189. *See generally* Susan Rose-Ackerman, *Putting Cost-Benefit Analysis in Its Place: Rethinking Regulatory Review*, 65 U. MIAMI L. REV. 335 (2011) (describing and critiquing cost-benefit analysis in regulatory review).

190. Administrative Procedure Act, 5 U.S.C. § 553 (2006).

191. *See* Asimow, *supra* note 18, at 402–03.

192. *See id.* at 403–04.

193. *See supra* note 152 and accompanying text.

materiality guidance represents an agency interpretation of a term used in existing law (both statutory and decisional) and regulation within the ambit of the SEC's mandate.

The former (APA notice-and-comment) approach permits a full public vetting of the proposed guidance. Yet, that traditional approach seems heavy-handed as a means of adopting a set of materiality guidelines for use by transaction planners, enforcement agents, and others in shaping their actions. The latter approach—issuance of an interpretive release or policy statement—seems more appropriate for this purpose and, if properly drafted as a nonlegislative rule,¹⁹⁴ may allow the SEC to reduce costs by issuing the release without compliance with the APA's notice-and-comment process. If the guidance constitutes a legislative rule, the SEC will be required to give notice and receive comments before issuing a final release including the guidance.¹⁹⁵

Although some may be concerned that the SEC is less familiar than the federal courts in working with presumptions or that the SEC lacks experience in designing rules that include presumptions, the SEC is no stranger to navigating and drafting presumptions. In fact, Rule 10b5-1,¹⁹⁶ one of the SEC's rules on insider trading, establishes a presumption of liability for insider trading based on an actor's awareness of material nonpublic information.¹⁹⁷ Other examples of the explicit and implicit use of presumptions in SEC rulemaking abound.¹⁹⁸ Accordingly, concern about SEC experience in this type of rulemaking is unwarranted.

194. See *supra* notes 24 & 25 and accompanying text.

195. See generally David L. Franklin, *Legislative Rules, Nonlegislative Rules, and the Perils of the Short Cut*, 120 YALE L.J. 276 (2010) (describing and addressing aspects of this problem); Thomas J. Fraser, *Interpretive Rules: Can the Amount of Deference Accorded Them Offer Insight into the Procedural Inquiry?*, 90 B.U. L. Rev. 1303 (2010) (same); Richard J. Pierce, Jr., *Distinguishing Legislative Rules from Interpretive Rules*, 52 ADMIN. L. REV. 547, 551 (2000) (same).

196. 17 C.F.R. § 240.10b5-1 (2012).

197. See *United States v. Causey*, No. H-04-025-SS, 2005 U.S. Dist. LEXIS 39619, *15 (S.D. Tex. Dec. 28, 2005) ("Rule 10b5-1 creates an *Adler*-type presumption that a defendant is liable for insider trading upon proof that he or she was aware of the material, nonpublic information when the securities trade at issue occurred . . ."); *Newby v. Lay* (In re Enron Corp. Sec., Derivative & ERISA Litig.), 258 F. Supp. 2d 576, 592 (S.D. Tex. 2003) ("The rule . . . create[s] a rebuttable presumption: a plaintiff makes a *prima facie* case that the defendant is liable for insider trading merely by showing that the defendant was 'aware of the material nonpublic information' when he made the purchase or sale of the securities." (emphasis added) (citation omitted)).

198. See, e.g., 17 C.F.R. § 240.19g2-1(b)(2) (establishing a rebuttable presumption of control in connection with national securities exchange and registered securities association compliance); 17 C.F.R. § 240.19h-1(f)(2)

Writing the release will be somewhat tricky, however, because of the nature of the information to be conveyed and the nature of the audience. The proposed materiality guidance is detailed and, in a number of aspects, technical. The audience is diverse, ranging from employees to officers and directors of issuers, to legal counsel, regulators, and the judiciary. How can an interpretive release convey the appropriate level of detail to give useful guidance (and minimize the costs of legal change) and at the same time reach all of these audiences?

I propose that the SEC issue the guidance in a question-and-answer (“Q&A”) or frequently-asked-questions (“FAQ”) format. The SEC has written many interpretive releases in a Q&A or FAQ format¹⁹⁹ and also includes on its website questions and answers culled from telephonic interactions between the SEC staff and the public (although the last supplement was in 2004).²⁰⁰ The SEC also hosts Q&A and FAQ pages on its website about a variety of topics.²⁰¹ A Q&A format allows for the segmentation of complex information and the presentation of that information in a user-friendly manner.

(2012) (creating a rebuttable presumption of control in connection with certain self-regulatory organization notices); 17 C.F.R. § 248.120 (instituting a presumption in defining control under Regulation S-AM); 17 C.F.R. § 275.204-2(a)(14)(iii) (noting a presumption of materiality in connection with record maintenance by investment advisers).

199. See, e.g., U.S. SEC. & EXCH. COMM’N, *Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products*, Release No. 33-8107, 34-46101 (June 24, 2002), available at <http://www.sec.gov/rules/interp/33-8107.htm>; U.S. SEC. & EXCH. COMM’N, *Regulation of Transfer Agents*, Release No. 34-17111 (Sept. 11, 1980), available at <http://www.sec.gov/rules/interp/1980/34-17111.pdf>.

200. See U.S. SEC. & EXCH. COMM’N, *Manual of Publicly Available Telephone Interpretations*, <http://www.sec.gov/interps/telephone.shtml> (last modified Feb. 2, 2007).

201. See, e.g., U.S. SEC. & EXCH. COMM’N, *Division of Investment Management: Frequently Asked Questions About Form 13F*, <http://www.sec.gov/divisions/investment/13ffaq.htm> (last modified Sept. 21, 2011); SEC. & EXCH. COMM’N, *Division of Market Regulation: Answers to Frequently Asked Questions Concerning Rule 10b-18 (“Safe Harbor” for Issuer Repurchases)*, <http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm> (last modified Nov 17, 2004); SEC. & EXCH. COMM’N, *Q&A: Small Business and the SEC*, <http://www.sec.gov/info/smallbus/qasbsec.htm> (last modified Nov. 14, 2009).

V. CONCLUSION

The Initial Materiality Article, concluded with the overall observation that

[f]air 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 insiders²⁰²

Almost ten years later, nothing has been done to further this agenda, despite the fact that, in the intervening time, the SEC and the U.S. Department of Justice have engaged in noteworthy enforcement of insider trading prohibitions under Section 10(b) and Rule 10b-5. Many of these public enforcement activities (inquiries, investigations, the commencement of legal actions, etc.) have involved the exercise of significant enforcement discretion. Uncertainties in the application of the materiality doctrine in insider trading actions raise questions about the fair, efficient, and effective use of that discretion.²⁰³ The materiality doctrine in U.S.

202. Heminway, *supra* note 43, at 1212.

203. See *supra* note 53 and accompanying text (concerning the possibility of bias in insider trading enforcement); Heminway, *supra* note 5, at 1046 (“If the basis for and substance of insider trading regulation under Section 10(b) and Rule 10b-5 are clarified, enforcement agents will have less opportunity to cloak their selective enforcement efforts—including those resulting from bias—in the unclear policy underlying and elements of U.S. insider trading regulation.”); Heminway, *supra* note 43, at 1169–70 (“If public and private enforcement of the 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.”).

insider trading regulation represents a significant area of uncertainty.

The SEC is capable of giving enhanced materiality guidance for use in guiding the decision-making and activities of transaction planners in a manner that does no violence to—and, in fact, is likely to improve—the system of insider trading regulation in the U.S. All that remains is for the SEC to develop the institutional will and marshal the necessary resources to act on the proposals outlined in this article, and others like them, relating to areas of uncertainty in insider trading doctrine. This is, unmistakably, no small task in the current unsupportive environment in which the SEC operates.

In the absence of that institutional will and those resources, federal courts hearing insider trading cases that raise issues addressed in the proposed guidance offered in this article can use that guidance in their decision making. The federal courts have constructed U.S. insider trading law in prominent part and can have a role in clarifying the doctrine. Because the guidance offered here distills important concepts from SEC rulemaking, interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant, and existing federal decisional law, it offers important persuasive authority to the judiciary (as well as to transaction planners and legal advisors).

For all of these reasons, this author's entreaty to the SEC and the federal courts regarding materiality guidance in the insider trading context: "Just do it!"