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The Materiality Standard; NYSE Amends Rules; FASB Proposed Guidance

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The recent increase in regulatory activity and marketplace discussion on the topic of disclosure has not been limited to the small business arena or small cap marketplace. Effective September 28, 2015, the New York Stock Exchange ("NYSE") amended its Rule 202.06 of the NYSE Listed Company Manual, which governs the procedures that listed companies must follow for the release of material information. Also, the Financial Accounting Standards Board (FASB) has issued two exposure drafts providing guidance and seeking comments on the use of materiality to help companies eliminate unnecessary disclosures in their financial statements and to determine what is "material" for inclusion in notes to the financial statements. Both exposure drafts solicit public comment on proposed amendments to the Statement of Financial Accounting Concepts published by FASB.

NYSE Rule 202.06 Amendment

As published in the federal register, the NYSE proposes to amend Section 202.06 of the Manual to "(i) expand the premarket hours during which listed companies are required to notify the Exchange prior to disseminating material news, and (ii) provide the Exchange with authority to halt trading (a) during pre-market hours at the request of a listed company, (b) when the Exchange believes it is necessary to request certain information from listed companies, and (c) when an Exchange-listed security is also listed on another national or foreign securities exchange and such other exchange halts trading in such security for regulatory reasons. The Exchange also proposes to amend Section 202.06 of the Manual to provide guidance related to the release of material news after the close of trading on the Exchange."

In particular, the amendment extends pre-market notification hour requirements to 7:00 a.m. Eastern Time prior to disseminating material news. Currently listed companies are only required to notify the NYSE a minimum of 10 minutes before they release material news "shortly before the opening or during market hours." Market hours begin at 9:30 a.m. Eastern Time. With the amendment, a listed company will be required to comply with the "Material News Policy" and notify the NYSE at least 10 minutes before disseminating material news between 7:00 a.m. and 4:00 p.m. Eastern Time. The NYSE notes that most companies release news related to corporate actions and other material events between 7:00 a.m. and 9:30 a.m. Material news has the potential to cause volatility in both price and volume and accordingly, the purpose of the rule is to allow the NYSE the opportunity to halt trading in certain circumstances, including where it needs to obtain more information about the news release.

The amendment includes an advisory from the NYSE requesting that listed companies delay the release of material news after the close of trading until the earlier of (i) publication of the company's official closing price on the NYSE or (ii) 15 minutes after the close of trading on the NYSE. This request is intended to facilitate an orderly closing process to trading on the NYSE. The advisory does not require that listed companies delay the release of material news but does make the advisory suggestion. Companies are still technically allowed to release news promptly at 4:00 p.m. upon market close when they deem appropriate.

Rule 202.06, as amended, will continue to require that listed companies release material news to the public by the "fastest available means." The amendment contains a statement that listed companies generally will be required to either (i) include the news in a Form 8-K or other SEC filing or (ii) issue the news in a press release to major news wire services, including, at a minimum, Dow Jones & Company, Inc., Reuters Economic Services, and Bloomberg Business News. Listed companies that comply with current NYSE requirements should not need to change their practices for publicly releasing material information as a result of this clarification. The amendment also removes a variety of outdated references, such as references suggesting that telephone, fax, and hand delivery are acceptable means of releasing material news under NYSE rules.

The amendment also includes clarification as to the imposition of NYSE trading halts both during pre-market and regular market hours. The amendment will allow the NYSE to institute a trading halt before the opening of trading for the release of material news at the request of the listed company. It is believed that the company itself has the greatest insight as to whether a trading halt would be appropriate in light of the news it intends to release.

Although a pre-market trading halt may only be imposed at the request of the company, the amendment will also allow the NYSE to temporarily halt trading to facilitate an orderly opening process, if it appears that the dissemination of material news will not be complete prior to the opening of trading on the NYSE. Upon the NYSE's implementation of a trading halt, other national securities exchanges, some of which maintain trading hours starting as early as 4 a.m., will also halt trading in the listed company's security. Nasdaq Stock Market Rule 4120(a)(1) includes similar provisions with respect to trading halts between the hours of 4 a.m. and 9:30 a.m.

Moreover, the amendment will provide that if a listed company releases material information during NYSE trading hours, the NYSE may halt trading and may request additional information from the company relating to (i) the material news, (ii) the listed company's compliance with NYSE continued listing requirements or (iii) any other information necessary to protect investors and the public interest. If the NYSE halts trading under these circumstances, it may continue the trading halt until it has received and evaluated the additional information provided by the company. Prior to the amendment, Rule 202.06 limited the NYSE's authority to halt trading to situations in which a listed company intended to release material news during market hours. Nasdaq Stock Market Rule 4120(a)(5) is similar to this portion of Rule 202.06, as amended.

FASB GUIDANCE

FASB has issued two exposure drafts seeking comment and providing guidance on the use of materiality to help companies eliminate unnecessary disclosures in their financial statements and to determine what is "material" for inclusion in notes to the financial statements. Both exposure drafts solicit public comment on proposed amendments to the Statement of Financial Accounting Concepts published by FASB. Both exposure drafts solicit public comment on proposed amendments to the Statement of Financial Accounting Concepts published by FASB.

Financial reporting concepts are complex and generally are determined with the guidance of the company's Chief Financial Officer, outside accountant and ultimately with comment and input from the independent accountant/auditor. However, legal counsel often does and should advise on concepts and facts which underlie the disclosure decisions and help guide management in making appropriate determinations. Accordingly, it is important that public company legal counsel have an understanding of the basics of financial disclosure and underlying principles and concepts, including the basics of GAAP accounting. In fact, the exposure draft for Qualitative Characteristics of Useful Financial Information completely defers to legal concepts in determining materiality. This firm's team is strong in that regard.

The first exposure draft is "Qualitative Characteristics of Useful Financial Information" and was issued September 24, 2015 with a comment cutoff date of December 8, 2015. The main purpose of the proposed amendments in this release is to ensure that the materiality concepts discussed by FASB align with the legal concept of materiality. In fact, the release defers the materiality concept to a question of legality rather than accounting.

In particular, the proposed amendment includes the addition of the following language:

"Materiality is a legal concept. In the United States, a legal concept may be established or changed through legislative, executive, or judicial action. The Board observes but does not promulgate definitions of materiality. Currently, the Board observes that the U.S. Supreme Court's definition of materiality, in the context of the antifraud provisions of the U.S. securities laws, generally states that information is material if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information. [TSC Industries, Inc. v. Northway, Inc.] Consequently, the Board cannot specify or advise specifying a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation."

As can be seen, FASB is taking the approach of a complete deferral to the legal concept of materiality, including the U.S. Supreme Court's interpretation.

The second exposure draft is "Notes to Financial Statements" and was issued September 24, 2015 with a comment cutoff date of December 8, 2015. The main purpose of the proposed amendments is to promote discretion on behalf of the board of directors of a reporting company in determining what disclosures are material and relevant to their particular company and circumstances. This release, together with the "Qualitative Characteristics of Useful Financial Information" discussed above, both further FASB's recognition that (1) additional explanation about how to appropriately consider materiality or entity-specific relevance in deciding which information to provide in the notes could be effective in reducing or eliminating irrelevant disclosures; and (ii) a reduction in volume of immaterial information would improve the effectiveness of the notes to financial statements.

FASB is aware of the issues that either prevent or inhibit the reductions in disclosures—in particular: (i) the requirement to communicate omissions of immaterial disclosures as an "error" to the audit committee (and thus making it easier to disclose than defend non-disclosure); (ii) litigation concerns (especially from activist shareholder groups); (iii) possible internal control changes required to support added discretion on disclosure; and (iv) possible SEC comments (again making it easier to disclose than defend non-disclosure).

The proposed amendments in the exposure draft would (i) allow for quantitative and qualitative considerations of materiality in determining disclosures and recognizing that some, all or none of the requirements in a disclosure section may be material (or not) to a particular company; (ii) refer to materiality as a legal concept; and (iii) state specifically that an omission of immaterial information is not an accounting error. The proposed amendment would also make conforming changes to the Accounting Standards Codification, including cross-referencing updates.

General Commentary on Materiality

The disclosure requirements at the heart of the federal securities laws involve a delicate and complex balancing act. Too little information provides an inadequate basis for investment decisions; too much can muddle and diffuse disclosure and thereby lessen its usefulness. The legal concept of materiality provides the dividing line between what information companies must disclose, and must disclose correctly, and everything else. Materiality, however, is a highly subjective standard, often colored by a variety of factual presumptions.

The guiding purpose of the many and complex disclosure provisions of the federal securities laws is to promote "transparency" in the financial markets. However, the task of winnowing out the irrelevant, redundant and trivial from the potentially meaningful material falls on corporate executives and their professional advisors in the creation of corporate disclosure, and on investment advisors, stock analysts and individual investors in its interpretation. The concept of materiality represents the dividing line between information reasonably likely to influence investment decisions and everything else.

Only those misstatements and omissions that are material violate many provisions of the securities laws, including the bedrock provisions requiring accurate financial reporting. In 1976, the U.S. Supreme Court set the standard for a materiality evaluation, which standard remains today. In TSC Industries, Inc. v. Northway, Inc., the Supreme Court held that information should be deemed material if there exists a substantial likelihood that it would have been viewed by the reasonable investor as having significantly altered the total mix of information available to the public.

Despite this standard, the concept remains fact-driven and difficult to apply. There are no numeric thresholds to establish materiality, and market reaction is inconsistent and not always available. Ultimately professionals and company management must consider all facts and circumstances available to them on any given day to determine the materiality of a given disclosure in light of the standard established by the Supreme Court in TSC Industries.

Generally, professionals and company management must look in the first instance at specific disclosure guidelines set out in the federal securities rules and regulations (such as Regulations S-X and S-K and Forms 10-Q, 10-K and 8-K). Second, professionals and company management must consider all facts presently affecting the company. For instance, a specific disclosure may be highly relevant in light of current economic conditions and of little importance in a different economic climate. Ethical issues are generally not considered material, unless specifically required by statute (such as the Foreign Corrupt Practices Act).

The SEC has issued guidance on materiality in Staff Accounting Bulletin No. 99 (SAB 99). Although SAB 99 is meant to clarify some materiality issues, many practitioners find that it confuses rather than clarifies. Really the guidance just reiterates that materiality cannot be defined by law or standards but must be determined anew for each fact and disclosure issue.

In determining materiality, practitioners should keep in mind Regulation FD, which prohibits the selective disclosure of material information. That is, Regulation FD requires that if material information is to be disclosed, it must be disclosed to the entire market, either through a press release or Form 8-K or both, and not selectively, such as to certain analysts or market professionals.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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