DEALBOOK

Corporate disclosure — not just a game

Window on Wall Street

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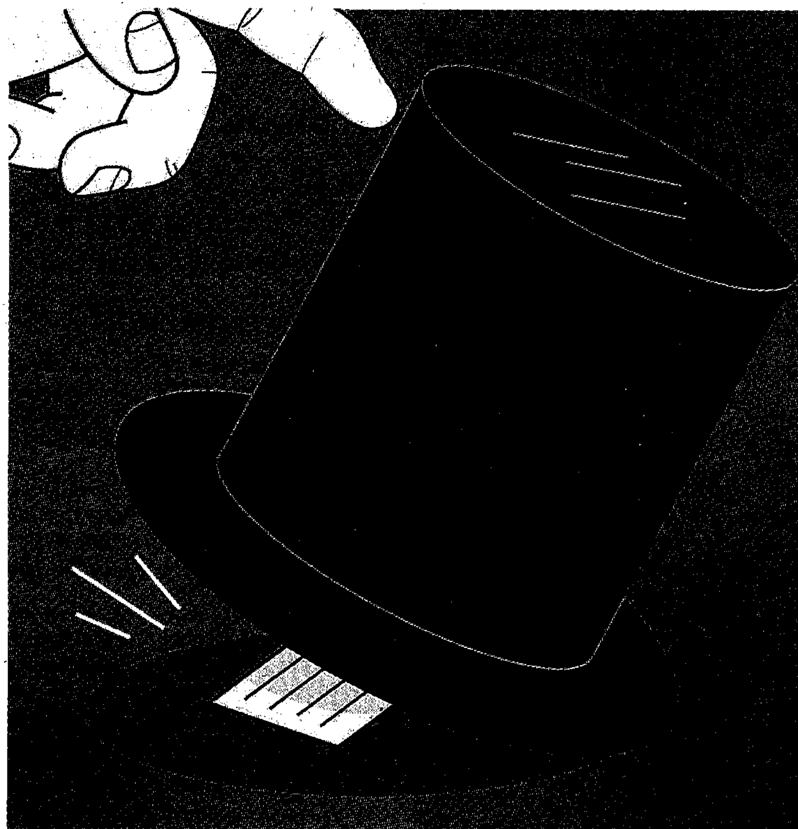
HARRY CAMPBELL

NEW YORK Why all the secrecy? It seems that each day brings a new revelation of a company's tardily disclosing something important. Goldman Sachs was slow to disclose an investigation into the Abacus transaction; Goldman, Procter & Gamble and AMR all said nothing when one of their directors, Rajat K. Gupta, became ensnared in the Galleon insider trading investigation. And there is the debate about what Apple should say publicly about Steven P. Jobs's health.

Most recently, Berkshire Hathaway said that a senior executive, David L. Sokol, had bought shares of a company before that company was acquired by Berkshire — a disclosure it made only when it announced Mr. Sokol's resignation.

It is all a matter of materiality.

U.S. securities laws are quirky about disclosure. They do not require, as the laws do in Britain, that all material information be disclosed continuously. Instead, U.S. companies need to file reports periodically with the Securities and Exchange Commission disclosing all material information. Certain categories of important information, like director resignations, are required to be reported within two business days. But most information is allowed to be reported quarterly or yearly.

Even then, disclosure of the information is typically required only if it is deemed material.

What is material information? It has been defined by the U.S. Supreme Court as involving "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

This is a subjective legal standard, so there is no bright-line rule for what is material.

Each situation is different.

The vagueness allows lawyers and others to argue that something is not material because they did not think it was certain or important enough to affect a company stock price significantly.

It is here that companies have gotten into trouble. A company's disclosure of controversial information is run past the lawyers, who look at it from a legal perspective. Since materiality is a legal concept to them, the lawyers too often find ways to judge it not material. It is not directly related to the business (Mr. Jobs), no official allegations have been made (Mr. Gupta), or it is not relevant to judging business performance (Abacus).

Information is a commodity; the faster one discloses, the better, from an investor's view.

Then there is the odd case of Mr. Sokol. Looked at from a legal perspective, the question of whether his trading violated insider trading laws is murky. One issue is whether the information he possessed, Berkshire's possible interest in acquiring Lubrizol, was material.

A court would look at this by assessing the probability of the Lubrizol transaction. Using current precedents involving insider trading, this assessment would be driven by Mr. Sokol's lack of final decision-making power in the transaction, which would limit materiality.

And the question of materiality in this context is a legal swamp, one in which there is anything but certainty. So, it may very well be that Mr. Sokol has a solid legal defense for his trades. (Mr. Sokol has said publicly that he did nothing wrong in his purchase of Lubrizol shares.)

The trial of Raj Rajaratnam, the Galleon hedge fund manager, on charges of insider trading raises the same kind of issue. His defense is the mosaic theory, an argument that he was only collecting bits of nonmaterial information that he then put together to make an investment decision.

To nonlawyers, these efforts to find distinctions between material and nonmaterial can seem baffling. If Berkshire Hathaway was looking to bid on a company, of course any investor would want to know. An investor would especially want to know if the person interested in the purchase was a top executive.

This is the problem with the current disclosure scheme and its definition of materiality. It is increasingly disconnected from the desires of investors and the marketplace. Investors live in a digital world of real-time communication. Information is a commodity whose value rapidly deteriorates — the faster a company discloses, the better, from an investor's perspective. The definition of materiality is from the 1980s, another time.

Companies have not kept up, and too often they view disclosure as a game in which the goal is to avoid disclosure.

This is what happened in another case of tardy disclosure, Bank of America's consideration of an effort to terminate the Merrill Lynch acquisition and Bank of America's subsequent bailout by the government, neither of which was disclosed until weeks after the fact.

Bank of America lawyers manipulated the information internally until they could take a position that it did not have to be disclosed.

Because materiality is a complicated legal standard, Mr. Sokol can defend trades that others see not only as unseemly but as an example of what insider trading laws should prohibit.

For investors' sake, companies need to view materiality from a broader perspective. It is not just about whether the S.E.C. could bring an action but about what investors would find important — in other words, would it move the market price? Common sense works here.

The information kept by Bank of America, Goldman and Berkshire was important to investors whether or not companies were required to disclose it immediately.

Companies need to understand that disclosure of information is not just a legal game. Failure to disclose important information on a timely basis can harm a company's reputation.

The S.E.C. could consider expanding disclosure requirements beyond periodic reporting. In current markets, disclosure may be better made on a real-time basis. Such a regulatory system has its own costs, as it would expose a company to more liability for misstatements in such disclosures. But a system of increased disclosure may be a trade-off for reductions in potential liability for such disclosure.

Then there is the question of materiality. The definition has become legally constrained, fraught with multiple interpretations and views. There is a need for renewed guidance, if not new legislation.

The definition of materiality is simpler and clearer if its test is what is important to the investor, instead of a calculation of whether the mix of information has been altered. It is more straightforward in Britain, which in determining what is material considers whether there would have been a significant effect on the share price.

A failure to act here may lead to increasing distrust of the markets by an already wary public.

Congress said it best when it adopted the Securities Exchange Act, the cornerstone of company disclosure, in 1934 under the concept that "there cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy."

The principle remains true today.

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