

Materiality in Review — Probability, Magnitude and The Reasonable Investor

Article

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Introduction

The crystal ball is an essential tool for compliance, and assessing compliance in hindsight, with the U.S. Federal securities laws, with particular reference to the Securities Act of 1933, as amended (the “1933 Act”), and the Securities Exchange Act of 1934, as amended (the “1934 Act”, and, together with the 1933 Act, the “Securities Laws”). The Securities Laws provide a framework for making available information that is sufficient to enable investors to make intelligent decisions as to whether or not to purchase or sell a security or approve a business proposal. This information is not only historical in nature but necessarily includes trends, uncertainties, contingencies and other forward-looking information. A company subject to the Securities Laws and its advisors have to make judgments as to the effect of possible future events or circumstances, in addition to the chance that those events or circumstances will actually occur. As if this task were not difficult enough, judgments then have to be made as to whether or not a hypothetical reasonable investor would consider the possibility of those events or circumstances important in making an investment decision. This note will explore the parameters within which such judgments are made.

Primary Liability Provisions of the Securities Laws

Perhaps putting the cart before the horse, it may be helpful first to review certain of the primary liability provisions of the Securities Laws in order to determine how best to provide adequate disclosure.

Related People

J.
Of Counsel
NEW YORK
+1.212.508.6123
tony.terrell@bracewell.com

- Section 11(a) of the 1933 Act imposes liability (subject to various exceptions and conditions) if a registration statement, at the time it became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. 15 U.S.C. § 77k(a).
- Section 12(a)(2) of the 1933 Act imposes liability (subject to various exceptions and conditions) if a security is offered or sold by means of a prospectus or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements [therein], in the light of the circumstances under which they were made, not misleading. 15 U.S.C. § 77l(a)(2).
- Rule 10b-5 of the Securities and Exchange Commission (the “SEC”), promulgated under Section 10(b) of the 1934 Act, in relevant part, provides that it is unlawful to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading in connection with the purchase or sale of a security. 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5 (2020).
- Section 14(a) of the 1934 Act and Rule 14a-9 promulgated thereunder provide, in relevant part, that it is unlawful to solicit a proxy with respect to a security registered under Section 12 of the 1934 Act by any communication that contains a statement which, at the time and in light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading. 15 U.S.C. §§ 78l, 78n; 17 C.F.R. § 240.14a-9 (2020).
- Section 14(e) of the 1934 Act provides, in relevant part, that it is unlawful to make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they are made, not misleading in connection with any tender offer or invitation for tenders. Rule 14e-3 of the SEC, promulgated under section 14(e), contains various proscriptions against the use of material non-public information. See 15 U.S.C. § 78n(e); 17 C.F.R. § 240.14e-1 *et seq.* (2020).

At the heart of these liability provisions of the Securities Laws are misstatements and omissions of material facts. Several other liability and anti-fraud provisions of the Securities Laws have similar or related bases, including without limitation Section 17(a) of the 1933 Act and Sections 13 (a), 13(b) and 18(a) of the 1934 Act and the applicable rules and regulations of the SEC thereunder.

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