

Standards for Determining Materiality in Securities Misrepresentations and Suggestions for Improving Price Sensitivity Standards

Hongxiang Wang^{1,a,*}

¹*Law School, Hainan Normal University, Haitao Street, Yanfeng Town, Hainan, China*
a. 202007070826@hainnu.edu.cn

**corresponding author*

Abstract: With the development of the securities market, cases of false statements are increasing day by day. Since the criteria for determining "materiality" have not yet been unified, there are disputes in academia and judicial practice. These controversies primarily revolve around three theoretical approaches: monism, which focuses solely on price sensitivity; dualism, which considers both price sensitivity and investment sensitivity; and ternary theory, which introduces additional criteria. This paper undertakes a comprehensive analysis of international standards for determining "materiality" and suggests that China should not only emphasize price-sensitive criteria but also incorporate investment-sensitive assessments to adequately reflect the complexities of modern financial markets. The paper also critiques the reliance on the price sensitivity standard as overly simplistic and potentially insufficient for capturing the full impact of false statements on market behavior. To address these shortcomings, the paper advocates for the involvement of professional institutions to independently verify the impact of false statements on stock prices, thereby ensuring more objective and reliable assessments. Furthermore, it is recommended that the burden of proof be shifted more heavily onto defendants in securities litigation, requiring them to substantiate their claims more rigorously.

Keywords: Securities misrepresentation, materiality, extraterritorial materiality determination standards, price sensitivity standards

1. Introduction

With the increasing prosperity of China's securities market, more and more cases of securities misrepresentation will emerge. Since January 21, 2022, the Supreme People's Court has issued the "Several Provisions on the Trial of Civil Compensation Cases of False Statement Infringement in the Securities Market" (Fa Shi [2022] No. 2, hereinafter referred to as the "New Judicial Interpretation"). It stipulates that criminal judgments and administrative penalties will be abolished as pre-procedures for civil compensation. The judgment standard for "materiality" has also changed from whether it has been subject to administrative penalties to the change in the trading price or trading volume of the relevant securities.

However, due to the lack of clear and unified standards, there have been many disputes in academia and judicial practice about the "materiality" identification standard. Establishing a unified standard

will help the court to hear the case, reduce the occurrence of judicial dispute cases, and greatly improve the efficiency and accuracy of the court's trial. For investors and securities companies, establishing a unified standard can avoid investors and securities companies being at a disadvantage in securities misrepresentation cases due to different judgment standards, which will help protect their legitimate rights and interests. It will also contribute to the healthy development of the securities market.

Based on this, this paper attempts to use judicial documents and how "materiality" is determined overseas as samples, conducts analysis through comparative law, and puts forward suggestions. The paper is structured as follows: after this introduction, Section 2 reviews the academic and judicial disputes surrounding the definition of "materiality". Section 3 compares these with international standards. Section 4 builds on previous analysis by proposing actionable measures aimed at refining the legal framework governing securities misrepresentation. Section 5 provides the conclusion.

2. Controversies Surrounding "Materiality" in Academic and Judicial Arenas

2.1. Academic Controversy Over "Materiality"

Academically, the identification of "importance" can be roughly divided into three categories: monism, dualism, and ternary [1].

2.1.1. Monism

Monism posits that "materiality" should be determined solely based on the criterion of price sensitivity. This approach argues that the primary, if not the only, indicator of a statement's materiality is its capacity to influence the market price of a security immediately after the information is made public. Proponents of monism advocate for this clear and quantifiable measure as it ostensibly provides a straightforward mechanism for assessing materiality, reducing ambiguity in legal contexts.

2.1.2. Dualism

Building on the foundational idea of monism, dualism introduces a second criterion: investor sensitivity. This theory acknowledges that not all material effects on a security's price capture the nuances of investor behavior and decision-making processes. Dualism thus evaluates "materiality" by considering both the direct impact on security prices and the broader implications for investor decisions. This approach aims to address scenarios where the price of a security might not immediately reflect the full extent of the underlying information's significance.

2.1.3. Ternary

The ternary framework expands further by incorporating an additional standard—the adverse impact on the issuer's quality—into the evaluation of "materiality". This includes factors such as the issuer's operational and financial conditions, which might not directly sway market prices but are crucial for long-term investor assessments. Ternary suggests that these broader criteria must also be considered to fully assess the material impact of disclosed information, advocating for a more comprehensive evaluation that encompasses both immediate and enduring effects on investor perception and company valuation.

2.2. Judicial Practice in Determining "Materiality"

Since the criteria for judging "materiality" have not yet been unified, there will be cases in which different criteria are used in judicial practice.

2.2.1. Dependence on Administrative Penalties

Since the promulgation of Article 85 of the Nine Civil Minutes in 2019, most courts have used whether a person has been subject to administrative penalties as a criterion to determine whether a false statement is material. For example, in the "Retrial Case of Zhu Tianwen Securities' Liability Dispute for False Statements" [2], the Supreme People's Court of the People's Republic of China held that the Shenzhen Stock Exchange's "Decision on Notifying and Criticizing the Yinglite Group" and Ningxia's Decision mentioned by Zhu Tianwen in the first and second instance prosecutions The Securities Regulatory Bureau's "Decision on Issuing a Warning Letter against Yinglite Group" was not an administrative penalty decision, so it was determined that Zhu Tianwen was not qualified for prosecution. It was determined that the rulings of inadmissibility made by the first-instance and second-instance courts were in compliance with the regulations, so Zhu Tianwen's case was dismissed. Application for reexamination. However, since the release of the new judicial interpretation, similar situations will no longer occur. The release of the new judicial interpretation not only greatly protects the legitimate rights and interests of investors, but also reduces the phenomenon of courts relying on administrative supervision. The court's determination of the significance of securities misrepresentations can be determined by professional institutions, which greatly increases the scientificity and rigor of case handling.

2.2.2. Emphasis on Price Sensitivity

The most widely used criterion in judicial practice has been the price sensitivity of the information. Courts frequently assess whether the disclosure of the false statement had a significant impact on the stock price to determine its "materiality". This method is grounded in the monistic theory, focusing on quantifiable market reactions as evidence of the statement's importance. For example, in "Guizhou Changzheng Tiancheng Holdings Co., Ltd., In the "Baoda Ming Securities Liability Dispute Case for False Statements" [3], the Guizhou Provincial Higher People's Court investigated and compared the stock price of Tiancheng Holdings Company on the disclosure date and trading day. The company's stock price increased for two consecutive trading days after Tiancheng Holdings Company released the "Performance Correction Announcement" After a drop of 10%, ST (special treatment), a drop of 5% for two consecutive trading days, and a drop of 5% for four consecutive trading days, it can be concluded that this event has a greater impact on the stock price, and can be applied to the price sensitivity standard. It is worth mentioning that some judicial cases adopt both price-sensitive standards and investment-sensitive standards, such as "Guizhou Changzheng Tiancheng Holdings Co., Ltd. and the respondent Jin Zaiyuan and the first-instance defendants Wang Guosheng, Ma Binlan, Zhou Lianjun, Huang Jufang, and Chen Lei Securities Liability for Misrepresentation" In the "Dispute Case" [4], the Guiyang Intermediate People's Court of Guizhou Province used the above two standards to determine whether the false statement was material. In addition, abstract expressions such as "sufficient to affect investors' decisions" often appear in court judgments, lacking strong arguments that have a significant impact on investors' decisions. It is difficult to say whether the starting point for determining significance is "investor rationality" or "court rationality" [5].

2.2.3. Consideration of Investor Sensitivity

While less common, some judicial decisions have also considered investor sensitivity—a key aspect of the dualistic approach. This criterion looks at whether the false statement would likely influence the decision-making process of a reasonable investor. This approach is more subjective and less observable than price sensitivity, making it a challenging standard to apply consistently. It requires a deeper understanding of investor psychology and market conditions that might influence how information is received and acted upon by investors.

2.3. Inadequacy of Price-Sensitive Standards

In the context of Article 10, paragraph 1, item 3 of the "New Judicial Interpretation", transaction price, transaction volume and price-sensitive standards are often linked together. Price-sensitive standards have the advantages of being highly realistic and operable, and it is relatively easy for referees to confirm them [6]. However, the following problems still exist.

2.3.1. Over-Simplification of the Judgment Process

One of the primary criticisms of the price-sensitive standard is that it may oversimplify the complex dynamics that influence stock prices. Courts often focus solely on immediate price fluctuations following the release of information, potentially overlooking other relevant factors that may affect market prices, such as economic conditions, industry trends, and unrelated corporate announcements. For example, in the Hainan Haiyao case [7], the court of first instance did not take into account other factors that affected the stock price. Instead, it held that the false statement did not affect the stock price on the grounds that the stock price did not fall during the week of the disclosure date. Therefore, there was no causal link between the investor's losses and the false statement. The change in stock price may be caused by the false statement, but it is not necessarily caused by this behavior. The change in stock price also involves the influence of various factors such as market and policy. If other factors that may affect the stock price are not taken into account and only the change in price or trading volume is used as the criterion, then there will be no relief for the losses caused by some small and medium-sized investors due to the misrepresentation.

2.3.2. Disproportionate Burden of Proof

In some cases, the defendant did not provide evidence to prove the impact of the false statement on the price. Yet, the court still held that the false statement did not affect the stock price, such as the "Baoshuo Co., Ltd. Case" [8], Baoshuo Co., Ltd. Co., Ltd. only provided a benchmark price calculation sheet. However, the Shijiazhuang Intermediate People's Court held that the stock price of Baoshuo did not fall significantly on the day when its false statements were disclosed, but rose slightly. Therefore, the court determined that the false statements were related to There was no causal relationship between the stock prices and the plaintiff's claim was dismissed. In most cases, the plaintiffs are mostly small and medium-sized investors with natural persons as the main body, while the defendants are mostly medium- and large-sized companies. Small and medium-sized investors are less advantageous than companies in terms of economics and ability to obtain information. Nonetheless, placing a lighter burden of proof on the defendant will be detrimental to the protection of the interests of small and medium-sized investors.

The challenges associated with the price-sensitive standard highlight the need for a more nuanced and multi-faceted approach to determining "materiality" in securities litigation. These challenges underscore the importance of developing additional criteria that consider both the immediate and long-term impacts of false statements, as well as the broader economic and market context.

3. Analysis and Adaptation of International Standards on "Materiality" in Securities Misrepresentation

As China's securities market continues to expand and evolve, the need for robust and adaptable legal frameworks becomes increasingly apparent. The complexity of the market demands a reassessment of existing laws to address emerging challenges effectively. By drawing insights from international standards, particularly from countries with established financial markets, China can refine its approach to securities regulation and ensure the sustainable development of its market.

3.1. Analysis of "Materiality" Standards in Common Law Systems

3.1.1. United States: Price-Sensitive Standards and Investment-Sensitive Standards

The United States has played a pivotal role in shaping the discourse on materiality in securities law. The evolution of materiality standards can be traced through several key court cases, which have progressively built a complex framework that considers both price and investor sensitivities.

In the 1976 TSC case, the U.S. Supreme Court's written statement on the materiality standard was: If a reasonable investor is likely to consider the fact to be important in deciding how to vote, then the omitted fact is Considerable. It can be seen that in this case, the court was more inclined to use the investor sensitivity standard as the criterion for judging "materiality" [9].

In the 1986 SEC vs. TGS case, the court proposed three different standards. The first is that the false statement will cause changes in market prices. Second, if the event is considered reasonably and objectively, it may affect the price of the company's stocks and securities; third, the event will affect the company's possible future and may affect investors' desire to buy, sell or hold the company's securities. The trial court held that if the information is material to investors, it will also have an impact on the price of the securities. Therefore, the court held that in a given situation, the materiality standard depends on the balance between the following two factors. In this case, the court used price sensitivity standards and investor sensitivity standards as the criteria for determining "materiality" [9].

The Basic case in 1988 developed the "possibility/degree of impact" standard based on the "rational investor" standard established in the TSC case. The Supreme Court held that if the impact of an event on the company is clear and clear, then the materiality standard established in the TSC case can be directly applied; however, if the event is probabilistic in nature or is only conjectural, it will be difficult to Assume that a reasonable investor would consider the omitted facts to be material [5].

3.1.2. UK: Price-Sensitive Standard

In contrast to the multifaceted U.S. approach, the United Kingdom has adopted a more streamlined, price-sensitive standard through its legislative framework. The UK's 1985 Corporate Securities (Insider Trading) Act defines "material information" as "information that the holder or public official knows is price-sensitive information with respect to the relevant securities". This definition targets insiders — such as corporate officers, major shareholders, and public officials — who are in positions to access non-public information that can influence the price of securities. The clear focus on price sensitivity means that the information must have a potential or actual impact on the market value of the securities to be deemed material.

This focus serves multiple regulatory purposes: it simplifies the enforcement of insider trading laws by providing a clear criterion for what constitutes illegal trading. It also helps maintain market integrity by ensuring that all market participants are operating on a level playing field, thus protecting investors from the manipulative practices that can arise from the misuse of undisclosed material information.

3.2. Analysis of "Materiality" Standards in Civil Law Systems

3.2.1. Japan: Enumerative Approach

Japan's approach to determining "materiality" in securities law is characterized by its reliance on an enumerative method. Rather than defining "materiality" through broad principles or subjective criteria, Japanese securities law explicitly lists specific instances of information considered material.

This method is clearly outlined in Japan's Securities and Exchange Act, which categorizes information into two main groups:

First, important facts, including definitive corporate actions and events that are likely to have a direct impact on stock prices or investor decisions. Examples include structural corporate changes like the issuance of stocks, capital reductions, mergers, and acquisitions, as well as operational milestones like the commercialization of new products and significant changes in profit distributions.

The other category is quasi-important facts, which covers information related more broadly to the company's operational aspects. It includes events like the establishment or dissolution of business partnerships, commencement of new business ventures, bankruptcy filings, and legal actions. These are considered material because they provide insight into the company's operational health and future prospects, which could influence investment decisions [10].

Japan's enumerative approach offers several advantages, including clarity and predictability for issuers and investors, as well as ease of enforcement for regulators. However, it may also have limitations, such as the rigidity of predefined categories, which might not always capture the full range of information that could be material in rapidly changing market conditions.

3.2.2. EU: Objective Price-Sensitive Standards

The European Union's handling of "materiality" is focused on the objective impact of information on market prices. The EU's framework, particularly as articulated in regulations like the Market Abuse Regulation (MAR), emphasizes price sensitivity as the cornerstone of materiality assessments. The MAR specifies that information is material if it is not yet public, pertains directly to the issuer or its securities, and is likely to have a significant effect on the prices of those securities.

This approach prioritizes transparency and market integrity, aiming to prevent abuses stemming from the asymmetric distribution of information. The EU's standards are designed to be broad enough to cover various types of information while maintaining a clear focus on the potential market impact, thus balancing comprehensiveness with precision.

3.3. Comparative Analysis and Inspirations

Since the standards for determining the "materiality" of false securities statements in the UK, the EU and China are relatively similar, we will not analyze them in detail here, but will mainly draw inspiration through the analysis of the United States and Japan.

The United States is noted for its flexible and evolving legal framework, which allows the concept of "materiality" to adapt to the complexities of modern financial markets. The U.S. approach, which incorporates a comprehensive analysis of both behavioral and case-specific elements, allows for nuanced assessments that consider a wide array of factors affecting the materiality of information. This method enhances the ability of the legal system to make informed decisions that reflect the current economic and financial realities, providing a robust mechanism to safeguard market integrity and protect investor interests.

In contrast, Japan's approach offers a clear and predictable method by explicitly listing the types of information considered material. This clarity is highly beneficial for market participants, who can rely on specific guidelines to inform their disclosure practices. The Japanese system reduces ambiguity and simplifies compliance, making it easier for companies to align their operations with legal requirements. Furthermore, this approach minimizes litigation risks associated with "materiality" by providing straightforward criteria that guide both enforcement actions and corporate disclosures.

For countries like China, considering these international examples could be particularly instructive. Integrating the flexible, case-oriented analysis from the U.S. with the clarity and specificity of Japan's

enumerative listings could create a hybrid model that offers both adaptability and predictability. Such a model would not only accommodate the diverse needs of a rapidly evolving market but also provide clear guidelines to ensure compliance and enhance enforcement efficiency.

4. Improving Measures for Determining "Materiality" in China

4.1. Adopting a New Dualism Approach

China's judgment standard of "materiality" should adopt "new dualism" as the standard for determining "materiality". This approach enhances the existing dualistic framework by integrating additional, case-specific considerations, moving beyond the restrictive confines of the ternary theory's adverse impact criterion. The ternary theory, while comprehensive, may inadvertently penalize poorly managed securities firms by exacerbating their financial instability prior to litigation, potentially leading to bankruptcy.

The new dualism approach proposes using price sensitivity as the primary criterion for assessing materiality, due to its objective and quantifiable nature. This standard provides a clear, measurable basis for judicial decisions, thereby reducing ambiguity in legal proceedings. However, recognizing the limitations of price sensitivity alone, this approach also incorporates investor sensitivity as a secondary criterion. This supplemental standard accounts for the less tangible, but equally significant, investor reactions to false statements, which may not immediately affect market prices but are crucial for a holistic assessment of materiality.

4.2. Enhancing Precision in Judgment Standards

The approach of relying solely on price sensitivity to determine "materiality" has shown to be somewhat imprecise in capturing the full spectrum of effects that false statements can have on the securities market. While price sensitivity is a clear and measurable factor, it does not always reflect the subtler, yet significant, impacts on investor behavior. To enhance the precision of the materiality judgment standards, it is recommended that China incorporate specific, enumerated criteria into its legal framework, similar to the practice in Japan. By defining explicit benchmarks for what constitutes a material change in the market—such as detailing the minimum percentage change in stock prices that would be considered significant following a false statement—the courts can more accurately assess the impact of such disclosures.

Adopting this enumerative approach would allow for a more precise and fair adjudication process by explicitly outlining the conditions under which information is deemed material. This would not only streamline legal proceedings by reducing ambiguity but also ensure that all relevant factors are considered in the assessment of a false statement's impact, thus protecting investor interests more effectively and enhancing the integrity of China's financial markets.

4.3. Professional Evaluation of Causal Relationships

The existing methods for determining the impact of false statements on stock prices can sometimes be overly simplistic, relying heavily on direct correlations without considering the multifaceted nature of financial markets. To address this issue, it is proposed that Chinese courts, or the parties involved in litigation, should have the option to engage professional institutions to conduct a thorough analysis of the causal relationships between stock price changes and false statements. This analysis should explicitly account for and exclude other influencing factors such as broader market trends, economic news, or sector-specific developments, ensuring that the evaluation focuses solely on the effects of the false statements.

This approach involves a detailed examination by experts who can dissect complex financial data and isolate the variables directly related to the misinformation. By doing so, this process helps to provide a more accurate assessment of how much a false statement has influenced investor behavior and stock prices, rather than attributing any market movement to the statement without adequate justification.

Incorporating professional evaluations into the judicial process enhances the credibility and reliability of the findings, supporting fairer outcomes in securities litigation. It ensures that financial institutions, regardless of their business capabilities, are held accountable only for the direct consequences of their actions, without being unjustly penalized for market shifts that are unrelated to their misstatements.

4.4. Addressing the Defendant's Burden of Proof

In securities litigation, the burden of proof on defendants can often be perceived as disproportionately light, particularly in cases involving complex financial data and market impacts. To address this imbalance and ensure more equitable legal proceedings, it is proposed that the burden of proof for defendants in China be significantly enhanced.

The defendant should add a new one to the original burden of proof: the defendant should evaluate the overall trend of the stock price after excluding factors such as market and policy, so as to judge the relationship between its behavior and the stock price. If the defendant fails to provide evidence or makes an error in providing evidence, the defendant must bear the consequences of adverse consequences. For example, in the *Aeterna Zentaris, Inc. Case* [11], the defendant's expert witness did not conduct an independent analysis of the case to determine the relationship between the false statements and the impact of the stock price, but instead refuted the plaintiff's expert opinion as a defense. Therefore, the court believed that the defendant should bear the consequences of unfavorable proof. By requiring defendants to independently validate their positions and disentangle their actions from other market forces, courts can make more informed decisions based on a fuller understanding of the case's merits.

5. Conclusion

Since the release of the "New Judicial Interpretation" and the cancellation of pre-procedures, the determination of the materiality of false statements in securities has become the primary controversial issue. This area has become particularly contentious due to the lack of a unified standard, leading to a diverse array of practices in judicial settings. Given this context, it is imperative for China to refine and standardize its approach to assessing materiality to enhance the consistency and fairness of its legal processes.

In cases of judging "materiality", through the analysis and learning of how to determine "materiality" outside the country, China should use "new dualism" to judge whether false statements are "material", and can legislate "materiality". The identification standards provide specific examples to facilitate court judgment. At the same time, for the price-sensitive standard, it should be improved from two aspects: first, through professional institutions to detect the causal relationship between the stock price impact and false statements; second, to increase the defendant's burden of proof to protect small and medium-sized enterprises the legitimate rights and interests of investors.

Implementing these changes would not only align China's securities regulations with international best practices but also strengthen the integrity and transparency of its financial markets. Such improvements are essential for the protection of investors and the overall health of China's economic landscape, ensuring that the securities market remains robust, fair, and responsive to both national and global developments.

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