

# MATERIALITY IN FOCUS: WHO'S A "REASONABLE INVESTOR"?



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# What Retail Investors Need

- ▣ More public companies in which to invest
- ▣ Freedom to accept the consequences of their choices
- ▣ Information that *efficiently* reduces uncertainty
- ▣ Regulatory clarity



Images were created by DeepAI and OpenAI's ChatGPT.

# Uncertainty

- Economic uncertainty, company specific challenges, regulatory changes
  
- Porsche going public in Sept. 2022
  - Uncertainties
    - Supply chain
    - Competition
    - Regulation & disclosure
  - Europe's largest IPO by market Capitalization (€ 78 billion)
    - 82.50 euros per Preferred Share
    - Going public offers growth opportunities but comes with exposure to market volatility



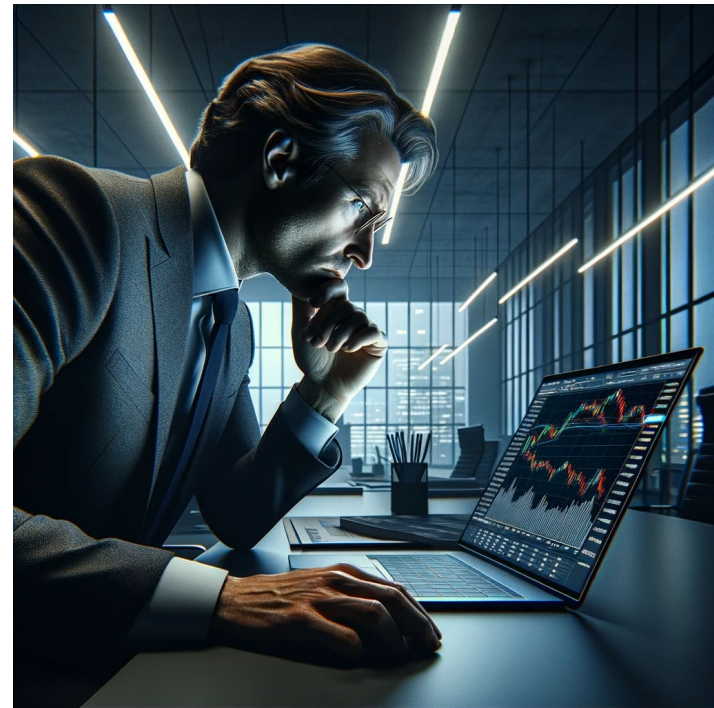
# Clarity on Materiality

- ❑ Material info is central to the smooth functioning of securities markets and successful retail investing
- ❑ Materiality revolves around the “reasonable investor”
- ❑ Who is the “reasonable investor”?
- ❑ PCAOB’s definition does not define “reasonable investor”
- ❑ SEC, prosecutors, plaintiffs, and courts disregard or misinterpret SCOTUS definition



# Materiality per SCOTUS

- TSC Indus. v. Northway (1976)
  - Substantial likelihood that reasonable investor would view the fact as significantly altering **total mix** of information
  - Delicate assessment of inferences made by a “reasonable investor”
  
- Basic, Inc. v. Levinson (1988)
  - **No single fact** determines materiality
  - Investors are **not children**; they can grasp even the probabilistic significance of merger negotiations



# Materiality vs. Statistics

Matrixx Initiatives v. Siracusano (SCOTUS, 2011)

- ▣ “**Spray your smell away**”
- ▣ Matrixx failed to disclose 23 reports of anosmia among millions of users
- ▣ District court dismissed b/c **no reasonable investor** would take 23 anosmia reports seriously
- ▣ SCOTUS: Reasonable investors **can infer cause without statistical significance**; total mix has no bright-line rule



# SEC & Tiny Big Data

SEC v. Bonan Huang  
(3<sup>rd</sup> Circuit, 2017)

Capital One fraud analyst (!) accessed millions of consumer card purchases (but only 0 – 4 % of any one company's) to predict retailers' revenues.



# Big vs. Tiny Data

SEC v. Bonan Huang  
(3<sup>rd</sup> Circuit, 2017)

Defendant argued that 0-4% was immaterial (tiny, like a mouse) compared to total revenues for any retailer and to the total mix of information (big, like an elephant).

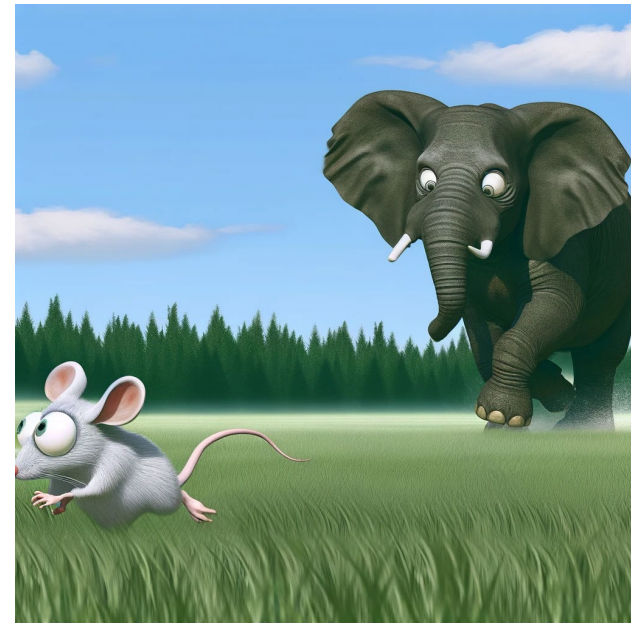




# Tiny vs. Big Data

Huang admitted to a **12,929% three-year return** on his investment informed by the **tiny slice** of Capital One data.

3<sup>rd</sup> Circ.: the slice “significantly altered the ‘total mix’ of information” in the eyes of a reasonable investor (Huang).



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# SEC v. SEC

The SEC's jury instruction vs. Bonan Huang included the following:

Material information is [that] which a reasonable investor **would** have considered significant in making an investment decision.

**Nonpublic information about a company's revenue is material.**



# Auditing Standards

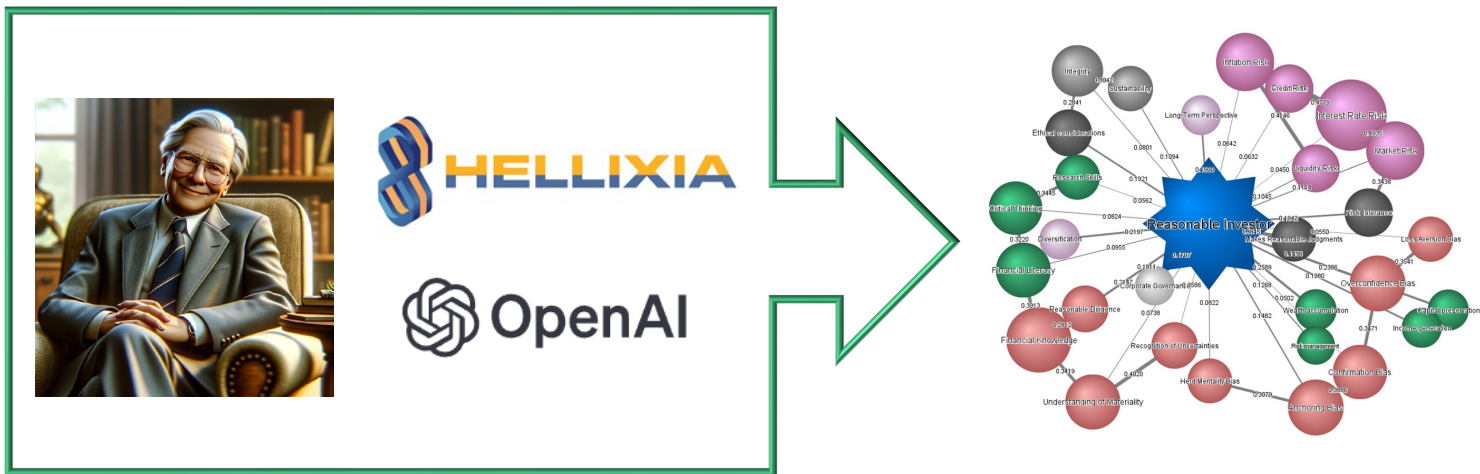
PCAOB	AICPA & IAASB
<p>AS 2105 cites <i>Basic &amp; TSC's</i> "reasonable investors" but offers <b>no details</b> about <b>behaviors or qualifications</b>.</p> 	<p>AU-C 320 &amp; ISA 320 (identical) <b>detail the behaviors and qualifications</b> of reasonable investors.</p>  

# AU-C 320: Reasonable users

- have a reasonable knowledge of business and economic activities and accounting and a willingness to study financial statements with reasonable diligence;
- understand that financial statements are prepared, presented, and audited to levels of materiality;
- recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- make reasonable judgments based on the information in the financial statements.

# Modeling the reasonable investor . . .

We used **OpenAI's ChatGPT** and **BayesiaLab (with Hellixia subject matter assistant)** to model "reasonable investor," using Warren Buffett's **value investing approach** and **AU-C 320.4** as prompts.



# Hellixia Bayesian Network

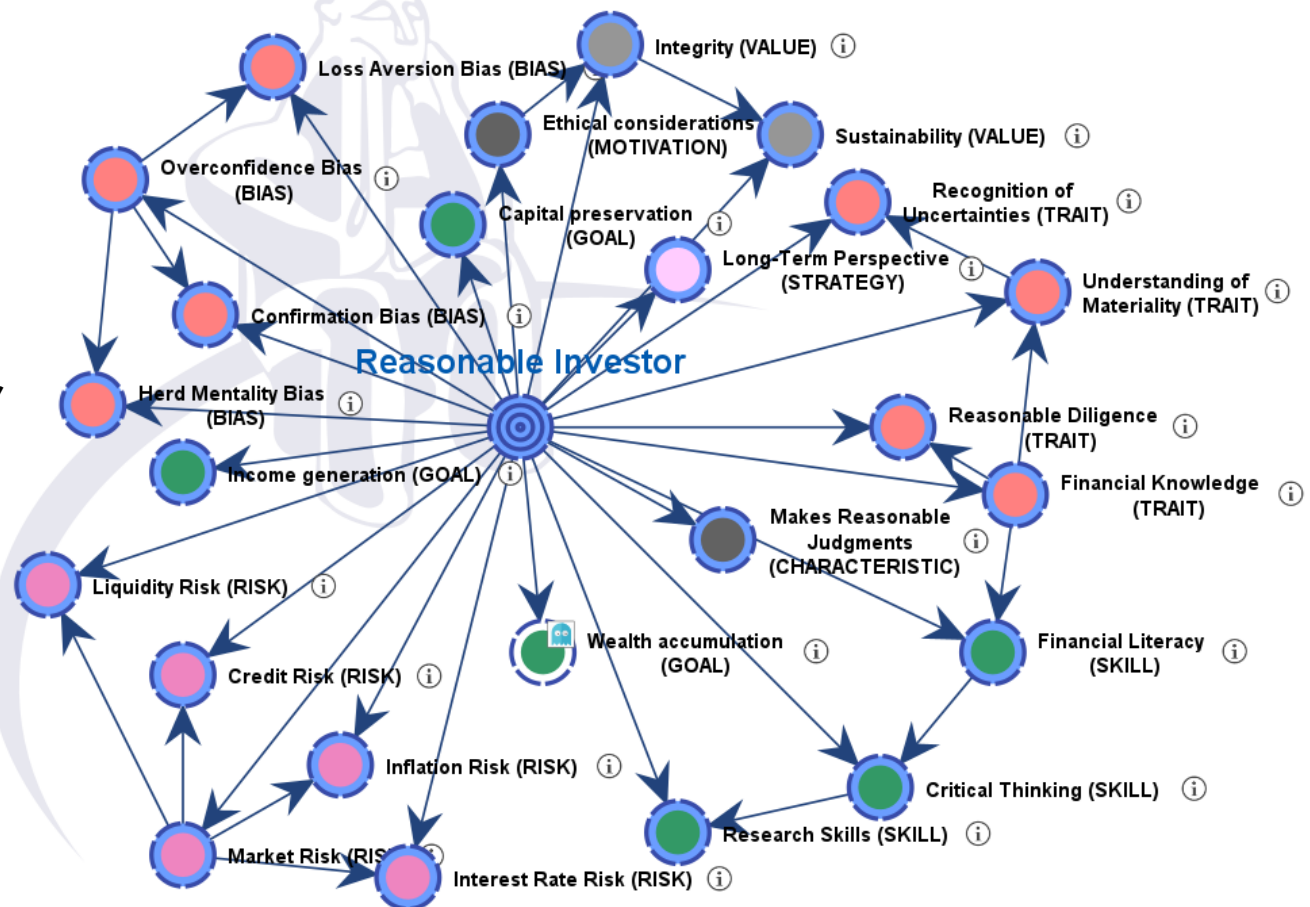


Keywords:

Risks, skills, goals, values, traits, biases, characteristics

Algorithm:

Augmented Naïve Bayes

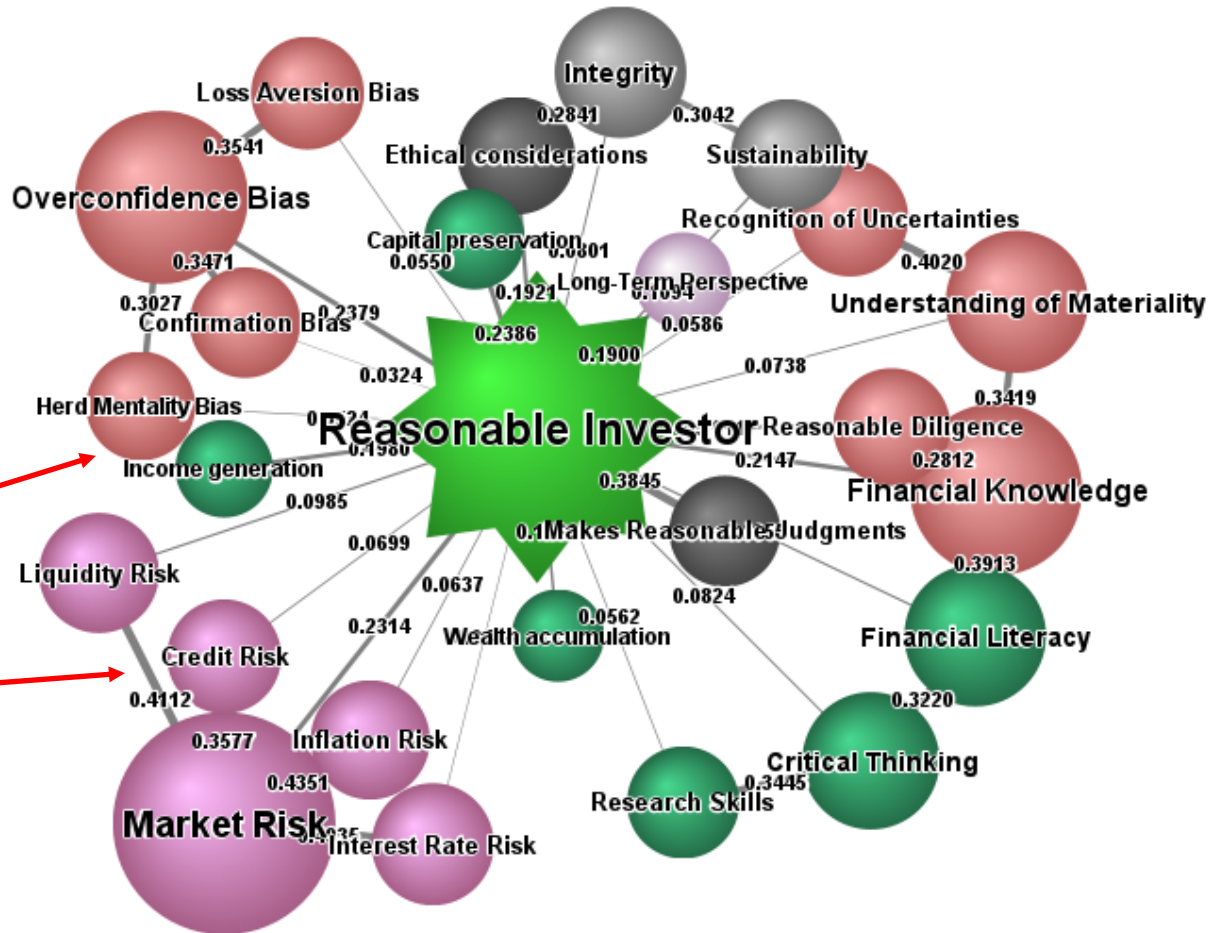


# Hellixia – Node Force view



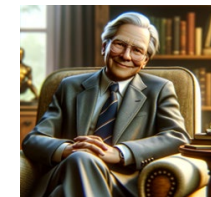
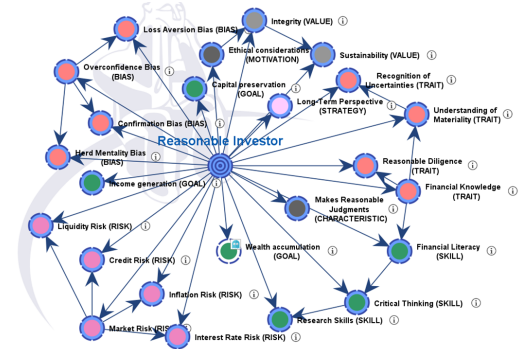
Which investor **traits** should be fostered? Which **risks** require special disclosure?

**Node size** = “Node force” = total KL divergence;  
**Line width** = strength of relationship.



# Protect who from what?

- How can we protect what we have not defined?
- Do *reasonable investors* sue because the company failed to disclose threats by other investors to sell over rumors that the company is “linked” to Satan? (See hypo in *Matrixx*, oral args.)
- Can we shrink “reasonable investor” to reduce false “unsafe content” events?





# Climate-Related Disclosures



**Gary Gensler**   
@GaryGensler



What does climate risk have to do with [@SECGov](#)?



12:21 PM · Mar 6, 2024 · 69.5K Views

# Climate-Related Disclosures

Registrants are required to disclose

- Climate-related risks and their impacts
- Transition plans and adaptive strategies
- Risk management and management role
- Scope 1 & 2 emissions (accelerated filers)

# Climate-Related Disclosures

The new rule points to the SCOTUS definition of materiality:

As defined by the Commission and consistent with Supreme Court precedent, a matter is material if there is a substantial likelihood that a **reasonable investor** would consider it important when determining whether to buy or sell securities...

(17 CFR 230.405, 240.12b-2.)

# Call for Clarification

- How can lack of clarity on materiality affect SEC registrants or deter private companies from going public?
  - Compliance Costs
  - Litigation
  - Investor Confidence
  
- Increased clarification on materiality would leave less room for misinterpretation

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# Time to move forward?

"You can't have this system where everyone is unable to move forward because everything is so ambiguous."

SEC Commissioner Hester Peirce (2023)

Speaking of the then lack of an SEC crypto-currency policy.



# Sources

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# Presenters

Thank you!

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