Legal Standard for Materiality of Securities Misrepresentation: Rational Investor and Price Sensitivity Test

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Abstract. In China's judicial practice, there are many difficulties in determining the transaction causation in misrepresentation securities transactions, and there is no uniform approach to the adoption of legal standards. Based on the current law, the latest judicial interpretation and cases, the author analyzed and identified limitations of the legal standards presently applied for transaction causation, and proposed a new method to apply the legal standards. The application of the rational investor standard should avoid the extreme tendency of over-weakness and over-strictness, and adhere to the combination of bottom-line thinking and the actual situation. The application of the price sensitivity standard should fully consider the shortcomings of its realistic basis, and avoid the simple application out of practicality, resulting in the determination of materiality losing scientificity. In addition, the rational investor standard and the price sensitivity standard have an inherent connection and consistency. The court should take the rational investor as the main judgment standard, and the price sensitivity standard as the bottom and supplement of the shortcomings of the rational investor standard, so as to reduce the uncertainty of judicial practice.

Keywords: transaction causation, fraud-on-market theory, efficient market hypothesis.

1. Introduction

Information disclosure is the main channel of communication between listed companies and investors in the securities market. The listed company holds first-hand data about its financial situation, while investors rely on the company's information disclosure to make decisions. Both parties are in the position of information asymmetry. Therefore, it is very important for investors that listed companies disclose information to the outside world timely and accurately. However, companies naturally have the tendency to hide the real information and mislead investors' decisions to illegally gain benefits. In order to maintain the fair, stable and healthy development of the securities market, it is necessary to strengthen the regulation of behavior that violates the information disclosure system.

With the booming development of China's securities market, there are numerous incidents of listed companies violating their disclosure obligations, among which misrepresentation is the most common. The causal relationship is a key element in tort liability. In the tort of securities misrepresentation, the judgment of the existence or otherwise of the causal relationship determines whether the tortfeasor can claim compensation for the illegal acts [1]. For a long time, China's legal regulations on the determination of causation of misrepresentation are insufficient. There are many difficulties in the determination of causation in judicial practice, resulting in the widespread phenomenon of different judgments in the same factor, and the rights and interests of most investors are not fully protected. In Certain Provisions on Misrepresentation 2022, a series of new provisions have been made on the determination of materiality and transaction causation, but there is still room for further clarification and refinement of the provisions about the review of materiality and the legal standards for determining materiality. The problems of irregular application of legal standards in judicial practice have not been completely solved. Therefore, it is necessary to further explore the problems existing in practice from judicial practice in order to better protect the rights and interests of investors and promote the healthy development of the securities market.

In the context of the new Certain Provisions on Misrepresentation and based on China's judicial practice, this article explores rules and legal standards for determining transaction causation. The author also draws inspiration from the jurisprudence of the U.S. courts to improve the rules of determination.

2. Independent Review of Materiality

Article 6 of Certain Provisions on Misrepresentation in 2002 made administrative penalty a precondition for determining the materiality of misrepresentation disputes, while in 2022 the new Certain Provisions on Misrepresentation deleted the provision of administrative penalty precursor procedure. Influenced by it, in judicial practice, many courts rely on the existence of administrative penalties to determine materiality without doing a specific review of materialities, such as Shanghai Shunhao New Material Case and Dengyun Auto Parts Stock Case [2,3]. It should be noticed that some courts have independently reviewed materiality despite administrative penalties that have been made, and ultimately denied the existence of materialities, such as the Hunan Investment Case and Shenzhen Energy Case [4,5]. There are different views in the academic community on the way of determining materiality.

View 1: The court need not review materiality. Li Guoguang stated that the determination of materiality can be resolved through the preceding procedures, and the court does not need to repeat the determination [6]. In addition, the determination of materiality, etc. involves financial expertise, and the court does not have the ability to review materiality, etc.

View 2: Courts should not directly rely on the existence of an administrative penalty to find materiality. This view holds that if the administrative penalty includes a determination of materiality, the court need not repeat the determination; if the administrative penalty does not involve a determination of materiality, the court should dismiss the suit. This view still does not actually give the court the authority to review materiality.

View 3: Courts should independently review materiality. Gong Liandii, Xie Chunhui stated that the court should use the price sensitivity standard or rational investor standard to analyze the facts of the case in order to determine whether it is material [7].

No matter from the theoretical perspective or based on the current practice, the court has sufficient conditions and reason to conduct an independent review of materiality. First of all, from the perspective of constituent elements, the constituent elements of administrative supervision to determine materiality are not the same as those in civil compensation. Ding Yuxiang points out that administrative punishment is an administrative responsibility in nature, which is aimed at protecting the public interest. Civil liability, on the other hand, protects private interests, and its function is mainly to compensate and remedy. The punitive purpose of administrative punishment determines that the standard of materiality is stricter. In the determination of civil liability, if the standard of administrative punishment is applied, it is tantamount to the standard of materiality with light liability, which is against the principle of proportionality in private law [8]. Secondly, from the perspective of judicial independence, for cases that have entered the judicial process, any issue involved should be independently examined by the court. The reliance on external procedures will undermine the independence of the judiciary, which leads to the risk of affecting the fairness of the trial. In addition, there is no necessary connection between administrative penalties and materiality. Administrative penalties may be sentenced even if the misrepresentation is not material. Thus, the court’s reliance on administrative penalties lacks a factual basis. With the modern construction of the judiciary, especially the construction of specialized financial courts, the professionalism of the judiciary is increasing, and the courts are gradually equipped with the ability to review issues involving accounting, finance and other specialties. Thus, the author concludes that the courts should conduct an independent review of the materiality of securities misrepresentation.

3. Legal Standards for Materiality

In judicial practice, when courts find materiality of misrepresentation, courts usually apply either the rational investor test or the price sensitivity test alone, or both (see Table 1).

Table 1. Tests applied by courts

Case	Judge's Opinion	Legal Standard
Yinji New Materials [9]	The misrepresentation of Yinji's investment did not necessarily lead to an increase or decrease in stock prices.	Price sensitivity test
Beida Fangzheng [10]	The information misrepresented had a significant impact on investors making investment decisions.	Rational investor test
Jinya Technology [11]	Jinya's misrepresentation had an impact on investors' willingness to buy and sell the stock, and also had a significant impact on the price of that stock.	Price sensitivity test and rational investor test

Thus, it can be seen that courts around the world have adopted different legal standards in determining materiality, and no uniform rules have been formed. The choice of legal standards directly determines the outcome of the judgment. Therefore, it is imperative to standardize and unify the selection of legal standards.

Next, this paper will discuss the application of the two legal standards separately and explain their inner connection, and try to make suggestions on the selection of standards in judicial practice.

3.1. Test of Rational Investor

As a commonly applied legal test, the rational investor test has several advantages. First, the rational investor standard starts from the investors themselves and determines materiality based on the degree of impact of the misrepresentation on the investors' decision-making. This standard reflects the value orientation of protecting investors' rights and interests. Second, the rational investor test has strong inclusiveness and flexibility, and can incorporate diversified factors such as the overall trend of the securities market, investors' own knowledge level, economic strength and risk appetite level for comprehensive consideration, which is conducive to adapting to the ever-changing securities market environment. Third, the rational investor test is a deterrent to information disclosure obligors, which is conducive to prompting them to consider the legal consequences of their actions when disclosing information, reflecting the concept of "sellers' prudence" and reducing the occurrence of misrepresentation at the source [12]. However, the rational investor test also has certain disadvantages. Fan Jian states that in judicial practice, due to overly abstract standards or the influence of the subjective consciousness of the judge, disputes cannot be effectively resolved in the trial, and it is hard to form a unified approach to judicial practice, resulting in different sentences in the same case [13]. In addition, regarding the test of rational investors, the Securities Law and the Measures for the Administration of Information Disclosure of Listed Companies adopt the expression of "whether the behavior is 'likely' to influence investors to make decisions or 'likely' to have an impact on stock price volatility". However, there is no detailed analysis of the word "likely", which may lead to differences in the courts' understanding and application of this standard.

The U.S. Court of Appeals for the Second Circuit adopted a weakened rational investor standard in the trial of SEC v. Texas Gulf Sulphur Co. The judge stated that the materiality element is present if there is a substantial likelihood that a reasonable investor would have considered the information to be material at the time of the security purchase and the information was not disclosed. The term "rational investor" has been interpreted to mean a low-demand, low-degree rational investor, i.e., the average person stated in traditional tort law [14]. In TSC Industries, Inc. v. Northway, Inc., the U.S. Supreme Court in criticized the weakened rational investor standard. The judge noted that the weakened rational investor standard increased the burden on the discloser and that the investor's decision was not based solely on false information, but rather on the totality of the information considered as a whole [15].

From the above U.S. court decision, it is clear that investors make investment decisions by referring to a range of information, instead of individual information. Under the "likely" label of the current law, a company discloses even a single piece of false information. It can be considered "likely" to influence the investor's decision. In fact, a single piece of information is not necessarily sufficient to influence investors' decisions. It must be noted that in extreme cases, as long as there is a misrepresentation of information, the relevant investors are able to sue for the misrepresentation, regardless of whether they have in fact made an investment decision by relying on the information, which will lead to the risk of abuse. Therefore, the expression "may" is obviously unfair to the defendant, and should take "sufficient" or "very likely" to determine the materiality of the action.

Regarding the judgment of the "rationality" of rational investors, Jia Jixing states that in securities transactions, rational and irrational factors exist simultaneously. It is obviously unfair to hold listed companies liable for irrational investments [16]. Therefore, in understanding the standard of rational investors, the court should avoid both the "weak standard of rational investors" and the "idealized standard of rational investors". The understanding of the rational investor standard requires the portrayal of a "rational investor" in line with the actual situation of the securities market in China as a guide for judicial practice. The court should combine the bottom line thinking and make a comprehensive investigation of the actual situation of the parties under the premise of defining the bottom line of the "rational investor model". In order to give full play to the flexibility of this test and promote the refinement of the trial, the court should take into account the factors such as the degree of education, economic strength, risk preference and investment experience.

3.2. Test of Price Sensitivity

Zheng Yu pointed out that the logic behind price sensitivity as a test for determining whether a misrepresentation is a material is that the disclosure of information can have an impact on the price of a stock in the direct securities market [17]. In addition, stock price, as an objective and easily ascertainable piece of information, is more reliable and operable in judicial practice than the abstract and subjective standard of the "rational investor". Thus, the price sensitivity test plays a unique and irreplaceable role in the determination of materiality.

In Basic Inc. v. Levinson, the U.S. Supreme Court established the fraud-on-market theory. The judge noted that in an efficient securities market, the public information of a public company is reflected in the movement of its stock price. The misrepresentation makes the company's share price no longer true and thus constitutes fraud on the securities market as a whole [18]. The fraud-on-market theory effectively recognizes that investors are justified in relying on the truthfulness and price fairness of the securities market. Therefore, the existence of causation can be found whenever the act of misrepresentation causes a fluctuation in the price of securities. However, the application of fraud-on-market theory in the Chinese securities market still needs to be critically thought through. The fraud-on-market theory is premised on the efficient market hypothesis. This hypothesis holds that in a strong efficient market, fluctuations in the price of securities can reflect both disclosed and undisclosed information in the market; in a semi-strong efficient market, fluctuations in the price of securities can reflect all disclosed information in the market; in a weak efficient market, fluctuations in the price of securities cannot reflect all disclosed information, but only historical information.

The fraud-on-market theory is based on the U.S. semi-strong stock market, i.e., stock prices that fully reflect the public information available in the market. However, China's securities market has not yet reached a semi-strong market, i.e., the stock price does not reflect the full range of public information in the market. Therefore, under the objective circumstances of China's securities market, investors' reliance on the "truthfulness and fairness of the securities market" lacks a factual basis, which makes the application of the price sensitivity test risky. In addition, Tang Xin and Zhang Ranran also point out that the market reaction has a lag. It is difficult to determine when investors are informed of information events that affect their decisions about changes in the market [19]. Thus, the author concludes that the full application of the price sensitivity test lacks a realistic basis in the reality of the securities market. It is invalid to determine materiality solely based on stock price fluctuations.

3.3. The Intrinsic Link between Rational Investor Test and Price Sensitivity Test

In the previous analysis, the author found that the rational investor test applies on the theoretical basis that information disclosure can have an impact on investors' decisions, and the price sensitivity test applies on the theoretical basis that information disclosure can have an impact on stock prices to a different extent, and this impact is realized precisely through investors' buying and selling activities. That is, investment behavior is the bridge through which the impact of disclosure is transmitted to stock price movements. Thus, the rational investor test and the price sensitivity test are not two independent criteria, but are intrinsically related to each other. Information disclosure can influence investment behavior, and at the same time, the disclosed information also indirectly influences securities prices through investment behavior.

In judicial practice, the application of the rational investor test and the price sensitivity test do not inherently conflict with each other, but can complement each other. In China's immature and rapidly developing securities market, the rational investor test with strong flexibility and comprehensiveness is appropriate as the main reference standard for materiality determination. And to deal with the risk of the influence of the judge's personal brought by the subjectivity of the rational investor test, it is appropriate to take the price sensitivity test as a supplement and underwriting, in order to minimize the uncertainty of judicial practice and promote the realization of fair justice.

4. Conclusion

Based on China's current law and judicial practice, and combined with the views of the U.S. courts' decisions on related issues, the author gets several paths to improve the rules for determining the causality of securities misrepresentation transactions. First, the court should get rid of the reliance on administrative punishment and conduct an independent review on the issue of materiality. Second, in the selection of legal standards, the rational investor test should be used as the main accordance of judgment, with the price sensitivity test as the underwriting and supplement. Third, in the specific application of legal tests, courts should adopt both the "weak rational investor standard" and the "harsh rational investor standard" in applying the rational investor test. The bottom line of the rational investor should also be taken into account. In addition, the abstractness and subjectivity of the rational investor test should also be noted. Regarding the application of the price sensitivity test, the stock price in China's securities market does not adequately and timely reflect the information based on the efficient market hypothesis, so the application of this legal standard lacks a factual basis and is thus unreliable.

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