

## The Materiality of Martha Stewart's Denials

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To constitute a securities fraud, a statement must not only be dishonest, but also material (or influential in the decision of a hypothetical reasonable investor to buy or sell the stock). A change in stock price can provide the best evidence of materiality to investors.<sup>1</sup> As detailed below, however, stock-price evidence of materiality in the Martha Stewart case is, at most, mixed. Her earlier written assertions of innocence were not material but her later, spoken statements were material.

On February 13, 2004, Judge Cedarbaum ruled that the jury would not hear testimony from Wall Street analysts and other experts about whether public statements Martha Stewart made influenced investors in her company.<sup>2</sup> Prosecutors in the Martha Stewart trial presumably had planned to use this testimony to establish materiality, and judges routinely allow accountants and financial economists to provide expert testimony regarding materiality. My analysis suggests that Judge Cedarbaum may have found the prospective testimony of the government's expert witnesses to be inadmissibly inconclusive.

Financial economists can testify as to whether or not an isolated disclosure or series of statements coincided closely with a change (in the right direction and big enough to establish statistical reliability) in the stock price of the company in question.<sup>3</sup> A stock that trades in an "efficient"

market can be expected to reflect all relevant information regarding the future profits of the company, and can be expected to adjust quickly to any news that changes the mix of publicly available information. The trading market for the common stock of Martha Stewart Living Omnimedia Inc. (MSO), which is listed on the New York Stock Exchange, qualifies as an efficient market.

Martha Stewart is accused, in part, with having deceived her company's shareholders by falsely denying that she had engaged in illegal insider trading when she sold her stock in Imclone Systems Inc. My review of press reports turned up four occurrences during the month of June 2002 when Martha Stewart issued denials.

The first occurrence was a written statement released on June 12.<sup>4</sup> This followed the early-morning arrest of Martha Stewart's friend, Dr. Samuel Waksal, on insider-trading charges. MSO opened down 7.1% from the closing stock price the day before, and closed for the day down 12.3%. The stock-price impact of this written statement might have provided useful evidence of its materiality had the market had time to digest the news of the arrest and indictment before the arrival of Martha Stewart's written statement, which became available no later than 10 a.m.<sup>5</sup> Although

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Generally, an amount is material for accounting purposes if it is greater than five percent of the appropriate benchmark amount, although the choice of benchmark is often disputed.

<sup>4</sup> The statement read: "I did not speak to Dr. Samuel Waksal regarding my sale and did not have any non-public information regarding ImClone when I sold my ImClone shares. After directing my broker to sell, I placed a call to Dr. Waksal's office to inquire about ImClone. I did not reach Dr. Waksal, and he did not return my call. In placing my trade, I had no improper information. My transaction was entirely lawful."

<sup>5</sup> There is no question that news implicating Martha Stewart in insider trading was bad news for MSO investors. An "event study" (that controls for the statistical tendency for MSO to fluctuate in sympathy with changes in the S&P 500 Index) shows that MSO

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<sup>1</sup> Financial economists define an efficient market as one in which all of the information that is relevant to the value of a stock is fully and quickly reflected in the stock price. Market efficiency is the logical predicate for inferring materiality from a change in stock price. If a price move in an efficient market is statistically significantly different from zero (an analysis that calculates the odds of observing as large a change in price by random chance alone, given the volatility of stock) then it is likely that there has been a material change in the mix of publicly available information.

<sup>2</sup> "Martha Stewart's Lawyers Score Legal Victory On Testimony," *New York Times*, February 14, 2004.

<sup>3</sup> In comparison, accountants can testify as to whether an amount is deemed material for accounting purposes.

the first occurrence of duplicative disclosures is the one most likely to change the mix of publicly available information, the close coincidence in time between news of the arrest and news of the first denial makes it difficult to isolate the stock-price impact of the first of Martha Stewart's repeated denials.

The second occurrence was a written statement issued after the close of trading on June 18 saying Martha Stewart had no inside information when she traded and was cooperating with Federal prosecutors, the SEC, and Congressional investigators. MSO opened for trading on June 19 at \$14.40, unchanged from the closing price on June 18. The opening price reflects substantial volume and trading interest because it is the price that clears a relatively large number of buy and sell orders (all those submitted before the start of trading). Consequently, the fact that the statement released after the close of trading on June 18 did not boost the opening price on June 19 above the closing price on June 18 reliably establishes that the written statement released by Martha Stewart on June 18 was not material to investors.

The third occurrence took the form of remarks made by Martha Stewart to an audience of the media and Wall Street analysts at a conference (Gannett's Mid-Year Media Review) held on the afternoon of June 19.<sup>6</sup> Her remarks apparently only reiterated the written statement she released after the close of trading on June 18, which did not itself move the stock price.

The stock-price impact of this first spoken statement may have been confounded by other news regarding MSO disclosed at the conference. Company executives issued "earnings guidance" by saying they remained comfortable with their

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stock declined by an average of 17.6% on three nearby days (June 7, June 24, and June 26) with news that tended to worsen Martha Stewart's perceived legal problem. The average is reliably non-zero as evidenced by a "t-statistic" of -6.18, where by convention a t-statistic below -1.96 (or above +1.96) indicates statistical significance or reliability.

<sup>6</sup> "Martha's Good Thing – Denial of Insider Trading Boosts Her Holdings By \$63M," *New York Post*, June 20, 2002.

existing forecast of 15 cents per share for the second quarter and 53 cents per share for the year. This guidance closely matched average First Call estimates (made by analysts following MSO) of 15 cents for the quarter and 54 cents for the year.

MSO closed on June 19 at \$16.45 per share, up 14.2% from the closing price on June 18.<sup>7</sup> The earnings guidance issued on June 19 met analyst expectations exactly. If the consensus analyst estimate was up to date, the guidance must have come as no surprise and thus could not have caused the price increase seen after the open on June 19. This leaves the spoken statement as the most likely cause of the significant price increase that day, which implies that her remarks were material.

In the fourth occurrence, the host of The Early Show on CBS on June 25 interrupted a salad-making demonstration with what was perhaps an unscripted question, and Martha Stewart responded that she would "be exonerated of any ridiculousness." For what it is worth, the price of MSO rose 8.4% (an adjusted 8.1%) on the day.<sup>8</sup>

Summarizing, while stock-price evidence is often the best evidence of the materiality of information to investors, the stock-price evidence against Martha Stewart is mixed. A spoken, in-person statement did move the price of MSO stock, but an earlier, written statement did not. There is little or no theoretical basis for assigning more weight to spoken, in-person statements. If anything, the greater evidentiary weight should be attached to the stock-price reactions to her earliest denials, as these are the ones most likely to have changed the mix of publicly available information. As it happens, the price response to the first denial is inconclusive and the price response to the second denial is exculpatory.

*Dr. Comment is not involved in the Martha Stewart litigation.*

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<sup>7</sup> After adjusting for the coincident change in the S&P 500 Index, the percentage stock-price change on June 19 (14.1%) is reliably non-zero as evidenced by a t-statistic of 2.90.

<sup>8</sup> The t-statistic for the excess return on June 25 is 1.65, which indicates no or borderline statistical significance.