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SEC Review of Disclosure Effectiveness

In her regular column on corporate governance issues, Holly Gregory discusses the SEC's announced initiative to review its corporate disclosure requirements.

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The quantity of corporate disclosure provided to shareholders and potential investors has exploded in the past several decades. While full and fair disclosure is critical to investor confidence, concerns about information overload are leading many to question whether, with respect to regulated disclosure, less would be more. The SEC is now undertaking a review of disclosure requirements to improve the SEC's disclosure regime for the benefit of both companies and investors. This review may lead to more narrowly tailored disclosure requirements, but it could also lead to expansion of disclosure in some areas.

Corporate counsel and the boards they advise should be informed about and follow developments in the SEC's review process. This article examines:

- The problem of information overload.
- Concerns about corporate disclosure identified by the SEC.
- The SEC's announced initiative to review disclosure effectiveness.
- Whether the scope of review should be comprehensive or targeted.
- Specific focus areas for corporate disclosure reform.

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THE PROBLEM OF INFORMATION OVERLOAD

Both companies and investors have expressed concerns about the expansion of corporate disclosure. Currently, mandated disclosures are costly and time-consuming. Some also question whether the focus of disclosure rules, at times, results in a skewed picture of a company's business and prospects. For investors, the volume and complexity of the information provided means that many of them, even sophisticated institutional investors, rely on third parties to digest and analyze the information and to provide vote recommendations, leading to questions about whether the useful information has become difficult to ferret out in the "noise."

Corporate disclosure is both a function of regulation and what a company decides to provide voluntarily. Companies are under considerable pressures from the threat of litigation to provide expansive disclosure, for example, in risk factors. Further, shareholders with special interests and others seek specific additional disclosures, for example, in the areas of corporate social responsibility and sustainability reporting. These often include non-binding shareholder proposals related to social policy and sustainability issues.

Search Corporate Social Responsibility for more on corporate social responsibility issues.

In addition, a variety of non-regulatory bodies periodically recommend new disclosure and disclosure standards for public companies. The sheer amount of information that companies must disclose has grown considerably since the early 1990s. While disclosure requirements mandated by the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) and SEC rules have played a role, disclosure practices have also been influenced by:

- SEC staff interpretations and guidance.
- The incentive for companies to protect against shareholder litigation through anticipatory and "safe harbor" disclosure.
- Investor demand.

CONCERNS ABOUT CORPORATE DISCLOSURE

Legitimate concerns have surfaced about the increasing volume, complexity and immateriality of corporate disclosure. Current and former SEC Commissioners have questioned whether investors are well served by the detailed disclosure about all the topics that companies currently provide in reports filed with the SEC. As disclosure documents become increasingly lengthy, legalistic, complex and repetitive, they may fail to clearly convey material information to investors.

Routine and reliable information is a key predicate to:

- The protection of investors.
- Fair and efficient capital markets.

However, mandated disclosure is subject to the Goldilocks principle. It is important to get the amount and level of the information provided to investors "just right." Too much information may cause problems, just as too little information may also cause problems.

In a January 2014 speech, Commissioner Daniel Gallagher expressed concern regarding the potential effect of too much disclosure:

> "[W]e need to take seriously the question of whether there can be *too much* disclosure. Justice Louis Brandeis famously called sunlight the best disinfectant. No doubt – but, as my friend and former colleague Troy Paredes pointed out some years ago, investors can be 'blinded by the light' of information overload. From an investor's standpoint, excessive illumination by *too* much disclosure can have the same effect as inundation and obfuscation – it becomes difficult or impossible to discern what *really* matters. More disclosure, in short, may not always yield *better* disclosure."
>
> (*Daniel M. Gallagher, Commissioner, SEC, Remarks to the Forum for Corporate Directors, Orange County, California (Jan. 24, 2014)* (transcript available at *sec.gov*) (emphasis in original).)

The need for a review of the SEC disclosure regime for reporting companies was identified by SEC Chair Mary Jo White in comments to the National Association of Corporate Directors in October 2013. The specific issues she raised included whether:

- Overlapping requirements that lead to duplicative information should be a cause for concern.
- Disclosure of risk factors, in part driven by litigation concerns, has become boilerplate and unwieldy.
- A principles-based approach would be better than the current focus on line items.
- Disclosures should be more tailored to specific industries.
- Companies should update a core document periodically with information about securities offerings, financial statements and significant events.
- The timing of required disclosures is appropriate.

(*Mary Jo White, Chair, SEC, The Path Forward on Disclosure (Oct. 15, 2013)* (transcript available at *sec.gov*).)

REVIEW OF DISCLOSURE EFFECTIVENESS

In December 2013, the SEC's Division of Corporation Finance formally recommended a broad review of disclosure effectiveness in a report to Congress that was mandated by Section 108 of the Jumpstart Our Business Startups Act of 2012 (JOBS Act) (Disclosure Report). The Disclosure Report considered how the requirements of Regulation S-K could be modernized and simplified to reduce the costs and burdens of these disclosure obligations for emerging growth companies. Among other things, the 105-page Disclosure Report recommended a comprehensive review of disclosure requirements for all public companies with a view to streamlining disclosure requirements based on consideration of the usefulness and materiality of information provided to investors.

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Specifically, the purpose of the review recommended by the Disclosure Report is to:

> "[E]nsure that existing security holders, potential investors and the marketplace are provided with meaningful and, to the extent possible in the Commission's rules, non-duplicative information upon which to base investment and voting decisions, that the information required to be disclosed by reporting companies continues to be material and that the disclosure requirements are flexible enough to adapt to dynamic circumstances."
>
> (*SEC Division of Corporation Finance, Report on Review of Disclosure Requirements in Regulation S-K (2013)*.)

The focus of the review is expected to be on:

- Regulation S-K, which sets forth requirements for non-financial statement portions of registration statements under the Securities Act of 1933 and for various ongoing reporting requirements under the Securities Exchange Act of 1934 (Exchange Act).
- Regulation S-X, which sets forth requirements for the format and content of financial statements.

In April 2014, the SEC added a spotlight page to its website discussing disclosure effectiveness. According to this web page, the review will focus initially on the business and financial disclosures required by periodic and current reports, Forms 10-K, 10-Q and 8-K. In a later stage, the focus will turn to the compensation and corporate governance information required to be included in proxy statements. The Division of Corporation Finance has invited comments on how to improve disclosure effectiveness.

ECONOMIC CONSIDERATIONS

According to the Disclosure Report, certain economic considerations should guide the SEC's review of any changes to current disclosure requirements. These include:

- Improving and maintaining the informativeness of disclosure to existing security holders, potential investors and the marketplace.
- The historical objectives of a given rule, including a consideration of any specific disclosure gaps, mandated policy objectives or other conditions sought to be addressed by a given requirement's adoption.
- A given disclosure requirement's administrative and compliance costs.
- The extent to which disclosure of a company's proprietary information may have competitive or other economic costs.

(*SEC Division of Corporation Finance, Report on Review of Disclosure Requirements in Regulation S-K (2013)*.)

COMPREHENSIVE v. TARGETED REVIEW

SEC Chair White has indicated that a comprehensive review is required, but this is not a view that is shared unanimously among SEC Commissioners. According to SEC Chair White:

> "We can all probably identify particular disclosure requirements that we might eliminate or modify, but that is not the kind of review and reform I am primarily focused on – and it certainly is not the kind of thoughtful and comprehensive review that I think our disclosure rules demand. I believe we should rethink not only the type of information we ask companies to disclose, but also how that information is presented, where and how that information is disclosed, and how we can take advantage of technology to facilitate investors' access to information and make it more meaningful to them."
>
> (*Mary Jo White, Chair, SEC, The SEC in 2014 (Jan. 27, 2014)* (transcript available at *sec.gov*).)

Commissioner Gallagher has indicated that he agrees that review of the corporate disclosure system should be a top focus of the SEC's reform agenda, but he has questioned the approach of undertaking a comprehensive review of SEC-imposed disclosure requirements, citing concerns about the substantial time it would take before any issues were actually addressed. He has suggested that there is value in targeted reform efforts and also in addressing reform of the proxy advisory industry (see *Daniel M. Gallagher, Commissioner, SEC, Remarks to the Forum for Corporate Directors, Orange County, California (Jan. 24, 2014)* (transcript available at *sec.gov*).)

POTENTIAL FOCUS AREAS FOR CORPORATE DISCLOSURE REFORM

At the Second Annual Institute for Corporate Counsel, Commissioner Gallagher suggested a number of focus areas for disclosure reform, including:

- **Layering disclosure.** This concept is based on the need to distinguish between information that is material, such as a company's financial statements and information that is not inherently material, for example, the pay-ratio calculation required by the Dodd-Frank Act.
- **Streamlining Form 8-K disclosure.** This would necessitate consideration about whether each of the categories of information now required to be disclosed on Form 8-K has such a critical nature that immediate disclosure is needed.
- **Reducing redundancy in filings.** This may be accomplished by providing clearer guidance on what issuers must disclose and what they do not need to disclose.
- **Simplifying proxy statements.** Clear and concise proxy statements would allow shareholders to better understand matters of material importance. A potential reform would be to permit some of the financial tables, other than the summary compensation table, to be included in an appendix.
- **Streamlining registration statements.** Forward incorporation by reference permits a registrant to automatically incorporate reports filed pursuant to the Exchange Act subsequent to the effectiveness of the registration statement. By permitting forward incorporation by reference in Form S-1 registration statements, registrants could avoid updating the Form S-1 filing after effectiveness either by supplements or post-effective amendments.
- **Increasing the reliability of SEC guidance.** This may be addressed by improving the reliability and authoritativeness of

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Disclosure Recommendations from KPMG and FERF

In their 2014 report on disclosure effectiveness, KPMG LLP and the Financial Executives Research Foundation, Inc. (FERF) focused on the significance of growing disclosure (and information) volume to users of financial statements, most significantly, professional investors. To obtain relevant insights, KPMG and FERF reviewed recent developments and commentary on disclosure, and conducted interviews with multiple professional investors.

The report's recommendations include the following:

- The SEC and the Financial Accounting Standards Board (FASB) should collaborate on standard setting to ensure an integrated set of disclosure requirements that is comprehensive and complete and avoids redundancies.
- The SEC and FASB should collaborate in identifying and publicizing appropriate guidance that is culturally embraced that will facilitate cross-referencing and addressing immaterial items.
- Summaries of significant accounting policies and their disclosures should be streamlined to eliminate unnecessary and immaterial disclosures, but should ensure that useful information about accounting alternatives and industry-specific principles and policies is presented.
- Preparers should use more tabular and graphic formats.
- The SEC should consider reinstituting a technology-enabled process to streamline updating public company information.
- Accounting standards that require disclosures in interim financial statements should specify the need for transparent disclosure of significant changes since the date of the latest interim and annual financial statements.
- The SEC and FASB should undertake incremental procedures to ensure that there is an appropriate and adequate cost-benefit analysis for new disclosure requirements, including extended field testing.

(*KPMG LLP and Financial Executives Research Foundation, Inc., Disclosure in the balance: Investors' perspective on information streamlining (2014)*.)

SEC disclosure guidance by issuing significant guidance only with the explicit endorsement of the Commission, rather than as SEC staff guidance.

- **Improving disclosure using technology.** Time should be spent exploring how technology can be used to improve corporate disclosure, for example, through the expanded use of data tagging.
- **Considering a standardized, online disclosure system.** This system would require one-time online disclosure of basic corporate information, with a mandate that it be updated as necessary, with changes tracked, rather than routinely repeated each year in annual disclosure documents.
- **Avoiding politically-motivated disclosure.** The Commission would monitor continuously and resist policymaker efforts to use the corporate disclosure regime to further social policy objectives, for example, as exemplified by new Form S-D.

(*Daniel M. Gallagher, Commissioner, SEC, Remarks at the 2nd Annual Institute for Corporate Counsel (Dec. 6, 2013)* (transcript available at *sec.gov*).)

THE ROAD AHEAD

Whether the SEC's review of its disclosure and reporting regime will result in any significant reduction in information overload remains to be seen. The process is likely to take considerable time regardless of whether the comprehensive approach or a more targeted approach is used. In addition, the review process will likely open the door for Commissioners, as well as investors and stakeholders with special interests, to seek expanded disclosures in specific areas, and therefore the review could result in more regulation.

As Keith Higgins, Director of the Division of Corporation Finance emphasized in recent remarks, while the goal of the SEC's review is to consider updating disclosure requirements to reduce the costs and burdens while continuing to provide material information, "[a]t the same time . . . we will ask whether there is information that is not part of our current requirements but that ought to be." He explained that while looking for ways to streamline disclosure requirements is important, reducing the volume of disclosures is not the sole end game. If potential gaps in disclosure or opportunities to increase the transparency of information were identified, the Division of Corporation Finance may recommend new disclosure requirements. (*Keith F. Higgins, Director, Division of Corporation Finance, Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting (Apr. 11, 2014)* (transcript available at *sec.gov*).)

Corporate counsel and the boards they advise should watch these developments closely. Some companies may wish to comment directly or participate in comments provided by industry groups.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.

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