The Path Forward on Disclosure

Chair Mary Jo White

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It is an honor to be with you today. The National Association of Corporate Directors has long played an important leadership role providing the insight and guidance that board members need to enhance shareholder value and effectively confront the various business challenges their companies face. The NACD has also been a very important partner to the SEC – providing valuable input on a number of our rulemaking efforts that affect companies and their boards of directors.

As members of boards of directors, each of you has an incredibly important job. You are fiduciaries and tasked with the oversight of company management – which requires a tremendous amount of time, knowledge and dedication. As a former director, I know all-too-well the heavy responsibility you have and the hard and time-consuming work involved to do the job properly.

One aspect of the job, which has taken on increasing importance in the last several years, is the role that you play in shareholder engagement and ensuring that management is considering the needs of investors in connection with the information that is provided to them.

The Need for Disclosure

At the SEC, one of the most meaningful powers that we have to wield on behalf of investors is our authority to require companies to tell investors about the things that matter to them.

I talked a bit about this in a speech two weeks ago, but I want to have a fuller dialogue about it with you today.[1] Without proper disclosure, investors would be unable to make informed decisions. They would not know about the financial condition of the company they are investing in. Nor would they know about how the company operates, who its board members are or what business, operational or financial risks the company faces, let alone may face in the future.

The core purpose of disclosure, of course, is to provide investors with the information they need to make informed investment and voting decisions. Such information makes it possible for investors to evaluate companies and have the confidence to invest and, as a result, allow our capital markets to flourish.

Today, companies are required to disclose – and include in reports filed with us – a whole host of different types of information, including:

- How they operate their business now and how they intend to do so in the future, and in some cases, how they did it before.[2]
- How much money they made over the last few years, as well as in the current year and how that might change in the future.[3]
- Specific details about large shareholders.[4]
- The money they have borrowed, repaid, will borrow and will repay.[5]

- A description of the background and experience of the officers and directors of the company, how much they are paid and why.[6]

Over the years, the list has grown and become more and more specific and more and more detailed, not all of which has been a result of our rules or guidance we have provided.

I am not suggesting that investors do not and have not benefited from each of the types of information that I just described. Certainly, much if not all of that kind of information may or could be relevant and necessary for investors, even if as some insist most investors do not take advantage of it.

Information Overload

But, I am raising the question here and internally at the SEC as to whether investors need and are optimally served by the detailed and lengthy disclosures about all of the topics that companies currently provide in the reports they are required to prepare and file with us.

When disclosure gets to be "too much" or strays from its core purpose, it could lead to what some have called "information overload" – a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant.[7]

The Supreme Court addressed this overload concern over 35 years ago in *TSC Industries* when it considered, in the context of a proxy statement for a merger, what should constitute a "material" misstatement or omission under the federal securities laws. In reaching its conclusion, it rejected the view that a fact is "material" if an investor "might" find it important. As explained by Justice Marshall, writing for the Court: "[M]anagement's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decision making."[8] Instead, the Court held that a fact is "material" if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[9]

Not too long before the *TSC* ruling, the Commission confronted a similar issue and held public hearings on what topics should be required in corporate disclosures. In the course of those hearings, it received suggestions of over 100 topics – a "bewildering array of special causes"[10] – ranging from charitable contributions to "good things a company has done."[11] Expressing the view that disclosure should generally be tethered to the concept of materiality, the Commission decided against requiring disclosure of the identified matters, noting that "as a practical matter, it is impossible to provide every item of information that might be of interest to some investor in making investment and voting decisions."[12]

We must continuously consider whether information overload is occurring as rules proliferate and as we contemplate what should and should not be required to be disclosed going forward.

The History of Disclosure Reform Efforts

There have been, over the years, many calls for the Commission to reconsider its disclosure requirements or to update them to make sure that companies are disclosing in a clear and straightforward way the most important and relevant information that a reasonable investor would read.

And since the 1960s, the Commission has periodically done that. Indeed, we have undertaken studies, created advisory committees, and issued interpretative guidance, concept releases, rule proposals and final rules all aimed at revising and enhancing the disclosure regime for securities offerings and periodic reporting. Many of these efforts have resulted in meaningful change.

In the 1970s, for example, an expert advisory committee recommended that the Commission create a single integrated disclosure system in which a single form would replace all registration and periodic reporting forms.[13] Following this report, the Commission adopted the first version of Regulation S-K – an overarching single, uniform set of rules that form the core of the integrated disclosure regime that we have today.[14]

As another example, in the mid-2000s, the Commission created an advisory committee that recommended scaling securities regulations for smaller public companies. That resulted in the elimination of Regulation S-B, which had set forth a specific disclosure regime designed for smaller companies that included special forms.[15] This effort to integrate and simplify disclosure for smaller companies was part of a larger effort to reduce burdens on these companies to enable them to access capital more quickly and efficiently. Although the Commission has considered different disclosure regimes for smaller companies in the past, and, more recently, Congress provided a new scaling for "emerging growth companies" in the JOBS Act,[16] the focus on scaled disclosures for smaller companies remains.[17]

Clearly, the topic of disclosure and a consideration of ways to make it better are perennial topics, as they should be. And, even though improvements have been made over the years, there is still more to consider and still, in my view, a lot more to do.

But before we can move to what changes and improvements might be made, it is important to understand what is in a filing today and why that information is in there.

Interestingly enough, Congress provided us with just that opportunity when it passed the JOBS Act in 2012. Section 108 of that Act requires us to comprehensively analyze the rules that form the underpinnings of our disclosure regime.

The objective of the Congressional mandate is to review our disclosure requirements and to consider how to approach modernizing and simplifying the requirements, and to also reduce the costs and other burdens of the disclosure requirements for emerging growth companies.[18] The staff of the Division of Corporation Finance is finalizing this report and expects to make it public very soon.

But the study is only the first step in any potential review effort. Such a review will need to be guided by answers to a host of questions that will move us forward on the path to more optimal disclosure. It is an important priority for me.

Where We Go Next

Given the number of initiatives and the amount of time spent over the years on the topic, there is certainly not a shortage of views. This is a topic that also often raises more questions than answers; I would like to explore a few of those questions with you today.

One question that I think we have to ask is whether there are specific disclosure requirements that are simply not necessary for investors or that investors do not want.

After all, the fundamental purpose of disclosure is to provide a reasonable investor with the information that he or she would need to make an informed investment or voting decision. We need to consider whether the disclosure regime as a whole is generating the information that a reasonable investor would need to make decisions.

As part of this effort, we need to look at requirements that may not be providing relevant information to investors in the most efficient manner. Some of our requirements may have been appropriate in the past, but may no longer reflect the reality of how businesses operate now or how investors use information today. For example, there was a time when a prospectus or an annual report was the most reliable and efficient way for an investor to obtain high and low historical closing price information about a company's common stock.

Given the widespread availability of this information on the Internet, we need to ask whether it is still necessary to require disclosure of historical share closing prices. Unlike the information in an SEC filing, the information investors can obtain on the internet can be current and can reflect data from as recent as the same trading day. And, when investors can generate the most current readily available information at the push of a button, then does it need to be in a report filed with us?

There are a number of similar examples, such as requirements for dilution disclosure or the ratio of earnings to fixed charges that also may be less relevant now than they may have been in the past.

The problem of disclosure overload, however, does not stem only from a few rule requirements that have outlived their usefulness. It also stems from other sources, which is why other questions should be asked, like:

Are our rules the sole or primary cause of potential disclosure overload or do other sources contribute to it? Or said another way, are changes to our disclosure requirements the only way to improve the quality of disclosure?

We should consider all sources that may be contributing to the length and complexity of disclosure. In some cases, lengthy and complex disclosure may indeed be a direct result of the Commission's rules. Or, it may stem from legislative mandates. But, there are other causes too, such as investor demand or a company's decision to take a defensive posture and disclose more information rather than less to reduce the risk of litigation claims that there was insufficient disclosure.

To illustrate my point, consider the lengthy "Risk Factors" disclosure in a few offering documents and annual reports. In 1995, Congress enacted the Private Securities Litigation Reform Act[19] that, among other things, addressed the concern that companies were often subject to securities fraud claims any time they made optimistic statements about the future that did not come true. The PSLRA, in essence, offered liability protection to companies by establishing a safe harbor provision for so-called forward-looking statements – statements about everything from projection of revenues, income, earnings per share, and dividends, to name a few.[20]

The safe harbors encouraged companies to share more "soft" information with investors, provided that they also included cautionary language that explained the important factors that could cause actual results to differ materially from what the company was saying. For example, a company could say that it believed that revenues could increase over the course of the following year, and couple that statement with factors that could impact the likelihood of that increase, such as actions by competitors or various market events.

Before 1995, risk factor disclosure was typically only provided in offering documents for higher-risk companies or securities. Over time, this cautionary language became more and more extensive, not necessarily because of a change in the SEC requirements for risk factor disclosure (although it is now required in the 10-K) but, at least in part, because of legal advice from attorneys assisting with the preparation of filings. It may be difficult or unwise to significantly walk those disclosures back, but it is fair to ask whether there is more there than is really needed. And, if this is not the result of an SEC or Congressional mandate, then it is worth asking what might be done if companies strive to reduce the length of these provisions on their own? These are among the issues that should be considered.

We see a similar phenomenon in the area of executive compensation disclosure – where the disclosures in some cases can amount to more than 40 detailed pages. The rules for such disclosure have been revised, perhaps, more times than any other set of disclosure rules as we have tried to keep pace with changing trends in compensation.

Part of this increase is not from new disclosure mandates, but from companies trying to do a better job of explaining the rationale for the compensation packages they pay executives because they now must provide investors with an advisory vote on executive compensation – a "say-on-pay" vote. The Dodd-Frank Act mandated such a vote, which most companies are providing annually.[21] And, as a result, companies have decided to more fully explain to their shareholders the rationale and considerations for these compensation decisions. And we think these additional disclosures are a good thing, but we should be careful not to have too much of a good thing.

We also should ask: Is there information that appears more than once in a filing, and if so, is that so bad? Or is there a way to avoid repetition in a document?

Here, I believe we need to first consider whether one set of disclosure requirements overlap with another set of requirements. For instance, if you want to get a sense of the litigation a company is facing, the annual report provides it very clearly. There is an entire section often labeled "Legal Proceedings," in which you can find the major law suits filed against the company, the investigations it is facing by federal and state authorities, and the likely settlements into which the company expects to enter.

Not surprisingly, the information appears elsewhere – namely, in the risk factors, in the MD&A and in the notes to the financial statements. Although the requirements for the legal proceedings disclosure differ somewhat from those that apply to financial statement disclosure, companies often simply repeat the information that is set forth in the financial statements.

We hear this complaint from companies about repetition. Accountants say that lawyers insist on the repetition and the lawyers blame the accountants. Rather than focus on who may be perpetuating this, we should simply figure out what investors want and whether such repetition is really such a burden for companies. Perhaps more importantly, we need to ask whether we need to harmonize these requirements.

In addition, we should consider whether we should have line item disclosures for certain topics or, instead, a principles-based approach.

After nearly a century in the making, our disclosure regime is not based entirely on line item requirements; rather, it is fundamentally grounded on the standard of "materiality." The staff has typically handled new "disclosure areas" and "hot topics" by starting with the premise that our rules require disclosure of material information. So, our disclosure experts have provided guidance about how to address particular topics within the framework of providing information that is necessary for exercising an investment or voting decision.

One recent example is cybersecurity, a hot topic from many perspectives. When the Commission adopted rules decades ago requiring a description of the company's business, risk factor disclosure and MD&A, there were no such things as smartphones, tablets, or even the internet. And, so it was not thinking about the risks presented by cybersecurity attacks or breaches.

Even though cybersecurity attacks were not specifically contemplated, the disclosure requirements generally cover these risks. That is because, even in the absence of a line item requirement, the basic standard of "materiality" governs. Depending on the severity and impact of the cybersecurity attacks, disclosure is either required or not. And the staff of Corporation Finance, relying on the materiality standard, issued guidance in October 2011 to help companies work through the disclosure questions that arise when considering cyber security matters.[22]

As we proceed down any reform path, we also should consider whether investors would benefit from disclosures that are more tailored to the industry in which the company operates.

For instance, the staff of the SEC has issued Industry Guides over the years to assist companies with respect to disclosure for a variety of specialized areas, including oil and gas, mining and bank holding companies.[23] All of these industries have changed drastically since they were published and yet the Guides have not often been revised.

The Commission adopted rules to update the disclosure guidance regarding oil and gas in 2008,[24] but other guides may also need updating.

Take for instance the mining industry. Like so many other industries, this has become an increasingly international one, and the international mining community actually has developed comprehensive standards for reporting resources and reserves. Several foreign jurisdictions use these standards in their securities laws. Should our Guide 7 disclosure guidance applicable to public mining companies here be modeled on the international standards?[25]

Similarly, bank holding companies use a guide originally published in the 1960s to provide disclosure about their operations. In the wake of the financial crisis and the changes that have occurred in the industry since the guide was published, some have called for this to be updated.[26]

An update to these guides could take a variety of forms. We could merely update them as guidance, or we could adopt actual rules. We would need to consider whether and how companies and investors would benefit from these options.

Finally, we must ask: Are investors getting the information they need when they need it? And are there ways that our rules can improve investors' access to a company's disclosure?

Consider that, prior to the early 1980s, companies filed their disclosure documents with the Commission on paper. Investors received information on paper because it was the only way.

In the early 1980s, the Commission developed its electronic disclosure system, EDGAR, and since that time has been continually improving electronic access to filings.[27] By 2002, the SEC website provided real-time access to company filings and companies themselves had begun using their own websites to provide information to investors.   Since the mid-1990s, the Commission has provided guidance on the use of electronic media to deliver information to – and communicate with – investors.[28]

Fast forward to today, a time when companies are using social media to connect with their investors like never before. Indeed, many people expect to have information pushed to their computers and smartphones almost instantaneously. This raises the question of whether company disclosure, and specifically the disclosure that is required by the SEC, should continue to be treated differently.

The current disclosure requirements for public companies require varying timeframes for disclosure depending on the nature of the information. The shortest is two business days – for disclosing the transactions and holdings of directors, officers, and beneficial owners.[29] Significant corporate events generally must be disclosed within four business days of the event.[30] Companies have more time to disclose quarterly and annual reports.[31] The information is no less important, but companies need more time to compile and prepare the disclosure and financial statements.

But given the ever increasing use of technology by virtually everyone, we need to think about whether the current timeframes in our rules and forms continue to be appropriate. In some cases, investors may benefit from receiving the information sooner than currently required. But we must also consider whether shorter timeframes would impose an undue burden on companies. There also may be concerns that requiring more frequent updates could lead to a decrease in the quality of the information.

In considering ways we can improve investors' access to disclosure, we should consider different methods of presenting and delivering information, both through our EDGAR system and other methods. We could explore a possible filing and delivery framework based on the nature and frequency of the disclosures, including a "core document" or "company profile" with information that changes infrequently. Companies could then be required to update the core filings with information about securities offerings, financial statements, and significant events. There are many different possibilities.

Conclusion

Clearly, there is no one system of disclosure that will satisfy everyone. Too much information for some is not enough for others. Too little for some, may be too much for others. And what some investors might want may not be what reasonable investors need.

But all the questions I posed today – and others – should be asked as we continue to refine the disclosure system that serves as the touchstone of our securities markets.

Although our study regarding Regulation S-K will only be the first step, it will set the stage for the dialogue and path forward toward a meaningful review of our disclosure requirements. I hope you will join us as we move that effort forward to create the optimal disclosure regime – one that serves the needs of investors and is embraced by businesses large and small.

Thank you.

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[1] "The Importance of Independence," October 3, 2013, *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539864016.

[2] *See* Item 101 of Regulation S-K [17 CFR 229.101].

[3] *See* Items 301-303 of Regulation S-K [17 CFR 229.301-303].

[4] *See* Item 403 of Regulation S-K [17 CFR 229.403].

[5] *See* Item 303 of Regulation S-K [17 CFR 229.303].

[6] *See* Item 401 of Regulation S-K [17 CFR 229.401].

[7] See*, e.g., Remarks at The SEC Speaks in 2013*, Commissioner Troy A. Paredes (February 22, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171492408#.UlwYERBf8rg.

[8] *TSC Industries, Inc. v. Northway*, 426 U.S. 438, 448-449 (1976).

[9] *Id* at 449.

[10] Release No. 5627 (October 14, 1975).

[11] *See id.*

[12] *Id.*

[13] *See* Report of the Advisory Committee on Corporate Disclosure, Cmte. Print 95-29, House Cmte. On Interstate and Foreign Commerce, 95th Cong., 1st. Sess (November 3, 1977).

[14] *See Adoption of Disclosure Regulation and Amendments of Disclosure Forms and Rules*, Release No. 33-5893 (December 23, 1977).

[15] *See Smaller Reporting Company Regulatory Relief and Simplification*, Release No. 33-8876 (December 19, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8876.pdf.

[16] Pub. L. No. 112-106, [126 Stat. 306] Secs. 101-107 (2012).

[17] *See* Recommendations of the Advisory Committee on Small and Emerging Companies (March 21, 2013), *available at* http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-smaller-public-co-ltr.pdf.

[18] Pub. L. No. 112-106, [126 Stat. 306] Sec. 108 (2012).

[19] 15 U.S.C. 77z-1 and 15 U.S.C. 78u-4.

[20] *Id*.

[21] 17 CFR 240.14a-21.

[22] *See* CF Disclosure Guidance: Topic No. 2 Cyber security, *available at* http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

[23] *See* Industry Guides, *available at* http://www.sec.gov/about/forms/industryguides.pdf.

[24] *See Modernization of Oil and Gas Reporting*, Release No. 33-8995 (December 31, 2008), *available at* http://www.sec.gov/rules/final/2008/33-8995.pdf.

[25] *See* Industry Guides, *available at* http://www.sec.gov/about/forms/industryguides.pdf.

[26] *Id*.

[27] The Commission began developing the EDGAR system in 1983. It established a pilot program for electronic filing and later permitted voluntary electronic filing before phasing in mandatory electronic filing for companies over a three-year period ending in 1996.

[28] *See, e.g., Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisers for Delivery of Information,* Release No. 33-7288 (May 9, 1996), *available at* http://www.sec.gov/rules/interp/33-7288.txt; *Use of Electronic Media*, Release No. 33-7856 (April 28, 2000), *available at* http://www.sec.gov/rules/interp/34-42728.htm; and *Commission Guidance on the Use of Company Web Sites*, Release No. 34-58288 (August 1, 2008), *available at* http://www.sec.gov/rules/interp/2008/34-58288.pdf.

[29] *See* Form 4 [17 CFR 249.104].

[30] *See* Form 8-K [17 CFR 249.308].

[31] *See* Form 10-Q [17 CFR 249.308a] and Form 10-K [17 CFR 249.310].