Columbia Law School

MILLSTEIN CENTER FOR GLOBAL MARKETS
AND CORPORATE OWNERSHIP

SESSION BRIEF NO. 4

Discussion on Transparent and Effective Disclosure

About the Millstein Center for Global Markets and Corporate Ownership

Building on Columbia Law School's longstanding strength in corporate and securities law, the mission of the Millstein Center for Global Markets and Corporate Ownership is to bring world class scholarship, research and academic rigor to the vital task of restoring and strengthening long-term financing of innovative and durable public corporations, which are the underpinning of economic growth.

This mission is essential given today's capital markets which are global, complex and volatile, and bring consequences and uncertainties to those who rely on them: companies, investors, and ultimately the wider economy.

The Center's research on the capital market and its impact on corporate governance and performance builds upon the work of the earlier successful "Institutional Investor Project" at Columbia University (1986-94), as well as the successes of the Millstein Center for Corporate Governance and Performance at the Yale School of Management (2005-12). The value of the Center's research is enhanced through active engagement with practitioners.

This paper provides a brief summary of discussion points, presentations, and findings from the "Discussion on Transparent and Effective Disclosure" event held in January 2015.

The Center's Session Briefings are framed as concise summaries of events or reports designed to promote policy discussion or further research. They strive to encompass a diversity of perspectives and are based on a combination of presentations, independent research, and the experiences of market leaders and thought leaders who participate in Center events or workshops. Participants generally include corporate board members and managers, institutional investors, advisors, leading academics, regulators, and other thought leaders.

Marcel Bucsescu, Executive Director of the Millstein Center served as lead editor. Jonathan Kim, former Senior Vice President, General Counsel and Secretary of Montpelier Re Holdings Ltd., and Rosemary Dodemaide, Operations Coordinator of the Millstein Center, served as secondary editors. Allison Mitkowski of Little Foot Communications served as the reporter.

The Millstein Center is extraordinarily grateful to all of its sponsors and partners, which provide support on an ongoing basis (a list of supporters can be found on the Center's website).

We would also like to extend a special Thank You to the Center for Audit Quality and Weil, Gotshal & Manges LLP for their collaboration, contributions, and participation in this event.

On January 22, 2015, the Ira M. Millstein Center for Global Markets and Corporate Ownership and the Center for Audit Quality hosted a Discussion on Transparent and Effective Disclosure. The following is a summary of the panel discussions.

The quandary over how much information to include in corporate disclosures has challenged companies, investors, and regulators for years. While corporations and regulators grappled with various models, investors have been left waiting for a streamlined and efficient solution to the disclosure reform dilemma.

The central proposition of corporate disclosures is to assist investors in determining what is material to a company and what may affect the company's prospects, either positively or negatively. On the surface, this goal appears to be simple and straightforward. Anyone who has ever read a prospectus or 10-K filing, however, can attest that there is nothing simple or straightforward about them. Disclosures are often redundant, overly couched in complex legalese, and lacking the proper context for investors to easily extract relevant information to enable them to make informed decisions.

The SEC's Disclosure Effectiveness Project aims to bring sweeping reform to disclosures by making filings with the agency more user-friendly, readable and relevant to investors. Input from investors, companies, and other stakeholders in the market will be critical to solving the disclosure dilemma. The recent panel discussion on this subject hosted by the Millstein Center raised interesting questions for debate, including the optimal platforms and channels for corporate disclosures and whether the SEC's current disclosure regime makes sense for investors in today's market environment.

Debriefing Disclosure Effectiveness

The SEC's Disclosure Effectiveness Project has its roots in the Jumpstart Our Business Startups Act of 2012 (JOBS Act), which required the SEC to review disclosure requirements in its Regulation S-K[1] and determine how the requirements could be modernized. SEC staff took a broader approach by examining how the disclosure requirements apply to all issuers and not just "large accelerated filers."[2] The Commission reviewed disclosure requirements that apply to periodic reporting in its Forms 10-K and 10-Q as well as current reporting in its Form 8-K. The SEC also evaluated its EDGAR (Electronic Data Gathering, Analysis and Retrieval) system to identify areas in need of improvement.

The Commission issued a report on its findings and recommendations in 2013,[3] and is now discussing next steps with investors, companies and other market stakeholders. One panelist introduced several recommendations from the report for the panel's discussion. Further study of Regulation S-K is at the top of the recommendation list, with a focus on identifying specific disclosure requirements that could be revised, updated, or eliminated. Another recommendation concerns long-overdue upgrades to EDGAR, which the panel unanimously agreed is both outdated and inefficient. The SEC is working to gather feedback from various stakeholder groups on its Disclosure Effectiveness Project, and is accepting comments from the public through its website.

One panelist noted that there are no surprises in the Commission's findings so far. Duplication of disclosure is a reoccurring theme, with the SEC finding redundancies even within its own rules. The Commission is coordinating efforts with the Financial Accounting Standards Board (FASB) to work more efficiently and to minimize duplication or overlap in public disclosure obligations. The panelist further noted that the Commission is contemplating industry-specific disclosure requirements within industry guidelines and Regulation S-K.

The SEC is also looking at certain disclosure requirements for entities other than registrants under its jurisdiction who must provide financial information under Regulation S-X.[4] A panelist noted that these requirements are potentially costly and challenging for firms, especially in cases where the entity in question is not controlled by a registrant. As such, the SEC is determined to gain a better understanding of how investors use financial information disclosed pursuant to both Regulations S-K and S-X. Any knowledge gained ideally will enable the Commission to refine disclosure requirements for the types of material information that investors need to make informed investment decisions.

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1 Regulation S-K sets forth initial and ongoing reporting requirements for SEC registrants under the Securities Act of 1933.

2 A "large accelerated filer" is a publicly listed issuer regulated by the SEC that, at the end of its fiscal year: had an aggregate worldwide market value of voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal year; has been subject to the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act) for a period of at least 12 calendar months; has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and is not eligible to use the requirements for smaller reporting companies in Part 229 of the Exchange Act for its annual and quarterly reports.

3 *Report on Review of Disclosure Requirements in Regulation S-K* Available at **web.law.columbia.edu/sites/default/files/microsites/millstein-center/materials_-_sec_-_review_of_disclosure_-_12.2013.pdf**.

4 Regulation S-X sets forth the specific format and content of financial reports mandated by Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Energy Policy and Conservation Act of 1975.

Along similar lines, the SEC is also reviewing scaled disclosure requirements for smaller and emerging companies (i.e. the opposite of large accelerated filers). This approach is based on the common theme evolving from the Commission's research that different levels of disclosure could be required for different types of companies. The concept aligns well with comments from panelists who agreed it would be a good idea to consider tailoring disclosures to better suit the unique needs of investors. One panelist opined that a one-size-fits-all model is not a viable option because each company is different. Another panelist discussed the idea of layered disclosures, which would allow investors to pick and choose the level of detail they wish to receive. A layering approach would enable a rules-based comparative of a general disclosure obligation (e.g. presentation of quarterly or annual earnings) that would become more specialized as investors drill down to the individual company level.

The discussion then moved to another SEC project that is currently underway focused on audit committees. Panelists discussed the importance of audit committee disclosures, saying such disclosures help investors better understand the public company audit process. The Center for Audit Quality (CAQ) has issued a call to action to provide real-life examples of how audit committees of publicly listed companies can enhance their companies' transparency. The panel discussed restructuring mandatory disclosures in order to enhance readability and narrative flow. They also discussed a critical improvement needed to clarify that a bank's audit committee is responsible for the appointment and retention of independent auditors. One panelist noted that it will be interesting to see whether the SEC might require additional disclosure regarding the audit process versus expansion of the audit committee report itself.

An Upgrade for EDGAR

In this day and age, companies are only as competitive as their technology. The same adage applies to the SEC, although government agencies often lack the budgets that corporations maintain in order to remain competitive in the technology space. So what is the SEC to do about EDGAR, which most system users and observers would agree is in desperate need of an upgrade?

One panelist commented that the system was not built for today's technology driven world. The system is slow to upload documents and has experienced system glitches, including distributing securities filings to certain investors before others. The SEC acknowledges that investors and other stakeholders often find it difficult to access information through EDGAR, and is taking on an EDGAR Modernization Project as a result.

The Commission is considering updates to EDGAR that would make the system more intuitive and user-friendly, such as organizing information more clearly and improving navigation tools. One comment raised during the panel discussion emphasized the value of functional search options so system users can easily find what they are looking for and can scan documents for specific information. In the end, however, it all comes down to money. The Commission needs greater financial resources in order to change with the times and fulfill its intended purpose. One panelist acknowledged that the SEC has consistently appealed to Congress for an appropriation to update EDGAR, but the agency has yet to receive funding to do so.

Balancing Benefit and Burden

The goal of the Disclosure Effectiveness Project is to balance costs and burdens placed on regulated issuers with the SEC's core mission of investor protection. The Commission has received a number of comments – many of which are in conflict or competition with one another. Comments have ranged from moving entirely toward a principle-based approach to calling for the elimination of any such approach altogether. One panelist noted that her organization had voted for an entirely principles-based approach as well as eliminating line-item disclosures. She acknowledged that such a construct, if adopted by the Commission, could trigger fear in some listed companies because information that an investor might find valuable could be overlooked or omitted. While this and other tensions will always exist, potential solutions are emerging in other areas, such as eliminating the requirement for disclosure of obsolete information like historical stock prices that can now be retrieved easily online.

While the SEC is aware of both the benefits and burdens of disclosure reform, finding solutions that will please everyone will be next to impossible. The challenge for the Commission will be determining which direction to pursue. In the meantime, companies can already begin to reconsider disclosure effectiveness on an individual level, since making changes to disclosure requirements in-house would not require any SEC action. One panelist commented that some companies are becoming creative with disclosure reform, particularly around modifying how information is presented in their 10-Ks. Other companies have completely eliminated disclosures that are no longer relevant.

Panelists who commented on the duplication issue agreed that a resolution is needed. They also acknowledged that disclosure reform is a costly undertaking. One panelist cautioned against a solely principles-based approach, or a requirement to have qualitative disclosure, because such approaches and requirements would make it more difficult for investors to compare companies and extract meaningful data. This is the main argument for mandatory rules, the panelist said. He offered a solution to this dilemma by suggesting that the Commission adopt simplified rules that make it easier for investors to compare companies and cull information from public disclosures. Another panelist acknowledged that disclosure reform is a daunting task, especially when there are competing interests and a pervasive "us versus them" mentality among corporations that must abide by disclosure rules.

Disclosure Reform: a Company's Friend or Foe?

As the discussion around disclosure reform continues, some companies are responding with frustration, and even fear, because registrants generally have been conditioned to expect comments from the SEC on filings. One panelist cited a published quote from an executive who said executives at several companies are skeptical of the SEC's move to limit disclosures and are wary of taking any action to voluntarily trim their disclosures. Another panelist agreed with this commentary, saying feedback supports the claims that companies are hesitant – and even scared in some cases – to jump into the disclosure reform waters. The litigation environment alone creates a dynamic where public companies continue to err on the side of caution by beefing up their disclosures instead of paring disclosure language down to more manageable and investor-friendly levels. There is also a feeling that the SEC's rules are outdated, wasteful and costly, which casts a negative light on the Commission's reform project.

Nevertheless, some companies are responding positively, and are taking the time to pinpoint where duplication exists within their current disclosures. There has also been discussion among companies that want more compliance flexibility, which one panelist found worrisome because investors often sense danger when they hear that issuers desire an easier path. The panelist said this question leads to the classic governance debate in which companies emphasize flexibility and investors are focused on oversight. The SEC has to land somewhere in the middle, so it's likely that neither side will be pleased with the final outcome.

The crux of disclosure effectiveness is examining what disclosure is trying to accomplish vis-à-vis both publicly listed companies and their investors. Redirecting the conversation in this direction would provide more interesting insights about disclosure rules, rather than talking in generalities about companies wanting flexibility and investors wanting oversight. The tension between the SEC and the issuers it regulates may be resolved by establishing common ground, since many companies are looking for better ways to communicate material information in their disclosures. One panelist commented that companies want to make changes, but detest preparing the attendant documents because current disclosures have become so unwieldy.

A panelist representing an investment firm was asked to weigh in on the investor perspective. He addressed disclosure mainly in the proxy statement, and acknowledged that the Compensation Disclosure and Analysis (CD&A) section is the area where he has seen the most innovation in companies using a public filing to improve their storytelling and communication with investors. While the most innovation was seen in the CD&A, from his firm's perspective the key disclosure focus should be on board composition. The panelist's firm encourages companies in which its clients invest to disclose information that will enhance investors' understanding of the mix of competencies, skill sets, experience, and qualities required by the companies' boards. The disclosures also inform investors about operational matters, including how board candidates are identified and selected, and how the board evaluates itself.

A panelist from a global bank commented that, generally speaking, the level of recent innovation seen in proxies has not yet hit 10-K or 10-Q filings. The question of what information goes into those disclosure documents is driven more by the kind of information that shareholders need. The stories that companies tell in 10-Ks and 10-Qs are comparable to the stories investors can find about board governance and a company's compensation philosophy and structures in a proxy. The panelist also noted a tension associated with the process of ensuring that disclosures are tailored to the client. For example, the speaker's employer has to abide by both SEC rules and bank regulations, which require additional disclosure. The bank must add or remove pages of disclosure that are either relevant or irrelevant depending upon the type of investor that comprises its current audience. The panelist also mentioned that the bank enhanced proxy disclosure by simplifying language and adding more visuals, such as charts, graphs and sidebars. The bank also incorporated a storytelling approach to craft the narrative, which, in addition to the "plain English" approach promoted by the SEC, made the document more readable.

Conclusion

It is clear that the SEC's Disclosure Effectiveness Project has a long way to go before meaningful changes emerge. That said, there is growing energy and an increasing appetite among a significant population of EDGAR users who want to see the system overhauled and updated to 21st century capabilities. Striking the balance between a principles-based approach and a prescriptive disclosure regime will continue to be the source of debate as corporations seek stable capital with minimal compliance costs while investors search for clearer investment opportunities without having to suffer an overload of information.

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