



## A Lofty Concept: Disclosure Effectiveness

Even before the JOBS Act had been proposed, policymakers focused on the downturn in the number of initial public offerings (IPOs) speculated that the burdensome disclosure requirements applicable to public companies were deterring private companies from undertaking public offerings. A number of market participants, including even a few then-Commissioners of the Securities and Exchange Commission (the “Commission”), noted that the disclosures contained in IPO prospectuses, as well as those contained in Securities Exchange Act (“Exchange Act”) filings, had consistently become longer in recent years. Then-Commissioner Paredes noted that disclosure overload brought with it the possibility that investors might no longer be able to identify the information that was material to an investment decision amidst pages of generic or repetitive text. In an effort to jumpstart the IPO market and reduce the regulatory burdens for IPO candidates, Title I of the JOBS Act (the “IPO on ramp” provisions) required that the Commission produce a report to Congress examining the requirements of Regulation S-K with a view to modernizing and simplifying the registration process for emerging growth companies (EGCs). The SEC Staff’s 2013 report identified a number of guiding principles that should inform a review of the effectiveness of disclosure requirements. Paramount among these is the notion of promoting investor confidence in the reliability of public filings through enhanced transparency, while encouraging capital formation. These and other objectives have been at the center of the Commission’s “Disclosure Effectiveness” initiative, which has been underway since 2013. Last week, the Commission took another step toward furthering its review of Regulation S-K requirements by voting to issue a Concept Release requesting comment on the business and financial disclosures that public companies provide in their Exchange Act filings.<sup>1</sup> The release specifically does not comment on the other disclosure requirements of Regulation S-K, such as corporate governance or compensation-related items, or the required disclosures for foreign private issuers, business development companies or other types of registrants.

### Overview

Given the public availability of information, investors are assumed to have access to disclosures made by reporting issuers—whether that disclosure is contained in filings made pursuant to the Securities Act of 1933 or the Exchange Act. Disclosures required pursuant to the Securities Act and the Exchange Act are coordinated through an integrated disclosure system. For U.S. domestic issuers, the required non-financial disclosure items are set forth in Regulation S-K, and the required financial disclosure items are set forth in Regulation S-X. In 1977, the

<sup>1</sup> Concept Release, Business and Financial Disclosure Required by Regulation S-K, Release No. 33-10064; 34-77599, available at: <https://www.sec.gov/rules/concept/2016/33-10064.pdf>.

Commission took its first step toward establishing an integrated disclosure system when it adopted Regulation S-K. Regulation S-K provides a single set of instructions to be used by registrants under the Securities Act forms, as well as the Exchange Act forms. Despite its significance, Regulation S-K has only been updated a few times since its adoption.

In the Concept Release, the Commission seeks comment on, among other things, whether the current requirements appropriately balance the costs of disclosure with the benefits, how disclosure requirements could be improved in order to enhance the information made available to investors, whether there are tools or approaches that can modernize the methods of presenting disclosures such that these are adaptable to changes in market conditions and advancements in technology.

In addition to requesting comment on various specific line items of Regulation S-K, as we note below, the Concept Release poses some fundamental questions regarding disclosure matters.

- ***Principles-Based Disclosures or Prescriptive Disclosures:*** The Concept Release raises the age-old “principles-based” versus “prescriptive” disclosure question. Currently, much of the information called for under Regulation S-K is principles-based and relies on the issuer’s assessment regarding materiality of the information in the context of the issuer’s business and financial condition. In considering “materiality,” the Commission has accepted the Supreme Court’s view that information is material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or how to make an investment decision. Information is material if there is substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information available. Of course, materiality determinations inevitably involve judgment and, as a result, may be difficult to apply, and application may lead to disclosures that are inconsistent from issuer to issuer. The release notes that there are other requirements under Regulation S-K that incorporate objective, quantitative thresholds or require that issuers disclose information in all cases. The use of prescriptive disclosure requirements is characterized as resulting in greater consistency and comparability among filings, which may be useful to investors, and in the case of some matters, even enables software to track and report these differences. The release solicits input on the most effective approach as between principles-based and prescriptive disclosure requirements and offers up a third concept, “objectives-based” disclosure requirements, for consideration.
- ***Investor Sophistication:*** The Concept Release asks an important question that often is the very first question we ask when we are writing a memorandum or an alert: in crafting disclosures, what level of sophistication should be presumed of the reader? As the release notes, the answer to this question affects not only the level of detail that is required to be disclosed and the type of information that is shared, but it also affects where (in which documents) the disclosure should be contained, the manner in which the disclosure should be required to be furnished (such as through cross-references, hyperlink or incorporation by reference) and the presentation of the information. Given technological advancements and the rapid accessibility of information, there is good reason to provide more flexibility for issuers in terms of how and where information is presented. In recent years, there have been a number of studies published by government agencies (some were required by the Dodd-Frank Act) regarding financial literacy and the way in

which investors review and react to disclosures.<sup>2</sup> These studies appear to suggest that investors prefer disclosures that are clear and concise, incorporating bullet points, tables, charts and other graphic presentations. Investors also appear to have a preference for “layered disclosure,” in which different formats (and amounts of text) co-exist for the benefit of different types of investors.

- ***Core Company Business Information:*** Item 101(a) of Regulation S-K requires a description of the general development of the business of the registrant during the past five years or such shorter period as the registrant may have been engaged in business. The release requests comment on whether this information is available elsewhere, whether the requirement is still useful for registrants with a reporting history, whether a more detailed discussion should be required every few years and whether the disclosure should contain a discussion of the registrant’s strategy or focus on changes that have occurred in the business. The release also asks whether, with respect to Item 101(c), any additional specific disclosures should be required.
- ***Scaled Disclosures:*** Scaled disclosures are available to smaller reporting companies (SRCs), and the JOBS Act made certain disclosure accommodations available to EGCs. Since enactment of the JOBS Act, market participants have urged the Commission Staff to review the scaled disclosures for SRCs in light of the EGC accommodations. Also, proposed legislation has been introduced that would redefine the filer categories (i.e., accelerated filers, non-accelerated filers, etc.) for various purposes, including in order to provide some relief from disclosure requirements that are perceived as potentially burdensome. The FAST Act also directs the Commission to revise Regulation S-K to further scale or eliminate disclosure requirements in order to reduce the burden on SRCs, EGCs and accelerated filers, while still providing all material information to investors. The release requests input on various issues related to scaled disclosures.
- ***Frequency of Disclosures:*** The release addresses the current debate regarding “short-termism” by acknowledging the possibility that quarterly disclosure requirements may lead the management of public companies to focus on near-term results rather than long-term investment. The release requests comment regarding the benefits or disadvantages associated with quarterly reporting, whether the reporting requirements should be different for different types of companies (i.e., for SRCs, EGCs, etc.), whether there would be significant savings or benefits associated with semi-annual reporting and some quantification of these costs.
- ***Cross-References, Hyperlinks, Layered Disclosures and Other Presentation Issues:*** The release solicits comments on the presentation of information and the extent to which tools or approaches can be used that would make information more accessible and reduce repetition and disclosure of immaterial information. The release discusses the use of cross-references, reliance on incorporation by reference, use of hyperlinks (including links to information that may be provided on company websites), use of standardized formatting (including standardized charts, tables, Q&As, etc., in order to promote comparability) and layered disclosures.

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<sup>2</sup> See, for example, Study Regarding Financial Literacy Among Investors, as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, delivered by the Staff of the Commission, available at: <https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>.

## Specific Areas of Focus

In addition to addressing and seeking comment on some overarching disclosure principles, the Concept Release also addresses a number of specific disclosure requirements, reviews the underpinnings of the current requirements and solicits input on potential areas of improvement that would provide more meaningful information for investors while not burdening issuers. We highlight below a few of the more important areas covered by the release:

- **Financial Information and the MD&A:** The release discusses the Item 301 selected financial data requirement, and asks whether this information is repetitive of information that is otherwise available to investors or whether there is utility to the data as it may highlight trends. Item 302 requires disclosure of certain quarterly data as to which the release solicits comments. The release also discusses the Commission's guidance over the years on the objectives of the MD&A section, the use of an executive-level overview and the types of trend data that the Commission has sought. In this regard, the release requests comment on various matters, including whether the sources of Commission guidance on MD&A should be consolidated, whether a different format or presentation should be required and whether auditor involvement should be required. The release also solicits comment regarding the current "two-step" guidance for determining whether forward-looking information is required in MD&A. As to results of operations, the release asks whether period-to-period comparisons should be retained, eliminated or modified; how the results of operations disclosures can be improved; and whether the three-year comparison provides material information that would not be reflected in prior period filings. The release also requests comment on the liquidity and capital resources disclosures (Items 303(a)(1) and (2)), off-balance sheet arrangements (Item 303(a)(4)), contractual obligations (Item 303(a)(5)) and critical accounting estimates (Item 303).
- **Risks and Risk Management:** The release asks whether all risk-related disclosures required to be included in a report should be consolidated and whether this would improve the quality of the information. This is an interesting approach and, in fact, in grouping in its Concept Release all of the "risk-related" items under a single heading and considering them together, the release seems to take a view. The release more specifically requests comment on whether and how registrants could be discouraged from including generic or boilerplate risk factors or risks common to an industry and instead focus on risks specific to the registrant and its business. Along these lines, the release asks for comment relating to additional requirements for specificity in the risk factors, more detailed discussion of context and the possibility of discussing the probability of occurrence of the factors identified in the section.
- **Line Item Requirements:** The Concept Release also seeks comment regarding specific items of Regulation S-K, including disclosure requirements relating to intellectual property rights (Item 101(c)(1)(iv)), government contracts and regulation (Items 101(c)(1)(ix) and (xii)), employees (Item 101(c)(1)(xiii)), properties (Item 102), number of equity holders (Item 201(b)), description of capital stock (Item 202), recent sales of unregistered securities (Items 701(a)-(e)), use of proceeds from registered securities (Item 701(f)) and purchases of equity securities by the issuer and affiliated purchasers (Item 703).

- **Industry Guides:** Consistent with the JOBS Act Regulation S-K study, the release solicits comments on the various industry guides and whether these guides require industry-specific information that is otherwise not disclosed and which remains useful to investors.
- **Exhibits:** The release also seeks input on Item 601 of Regulation S-K related to exhibit requirements. In particular, the release focuses on whether schedules and attachments from filed exhibits should be omitted and under what circumstances, whether registrants should continue to be required to file amendments or modifications to previously filed exhibits, whether it is clear which contracts are entered into in the ordinary course and whether it would be helpful for the Commission to provide additional guidance to help registrants determine which contracts should be filed to the extent that the registrants are “substantially dependent” on these.

## What to Expect

For many years, the SEC and issuers have struggled with how to best provide material disclosure to investors. In recent years, many issuers have undertaken initiatives to make their public disclosures more effective through the use of charts, tables, and other graphics. This trend is most evident in proxy statements, with many issuers having concluded that more effective disclosure of executive compensation and governance information provided a better platform for engaging directly with stockholders. Further, at the urging of the SEC Staff, numerous issuers have also sought to make the disclosure in their periodic reports and registration statements more effective, although the changes in these filings have been much more modest. One of the often-cited concerns in “voluntarily” paring back disclosures that may be immaterial, minimizing repetition, and deleting “generic” risk factors is that significant disclosure changes may open the door to potential securities litigation. The Concept Release now suggests a willingness on the part of the Commission to consider many of the basic underpinnings of Regulation S-K that could bring about meaningful changes to the ways in which public reporting companies share information with their stakeholders, and therefore represents one of the best opportunities in a generation to make some real progress in the way that public companies communicate with their investors.

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