Consumer Federation of America

July 25, 2016

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Business and Financial Disclosure Required by Regulation S-K (File No. S7-06-16)

Dear Secretary Fields:

I am writing on behalf of the Consumer Federation of America[1] in response to the Commission Concept Release, "Business and Financial Disclosure Required by Regulation S-K." The Concept Release addresses important issues related to the content and presentation of business and financial disclosures that are crucial to the transparency and efficient functioning of our securities markets. As explained in the Release, the purpose of this inquiry is to assess whether the business and financial disclosure requirements in Regulation S-K "continue to provide the information that investors need to make informed investment and voting decisions" and whether any of the Commission's rules "have become outdated or unnecessary." Based on the responses we've seen and the discussions we've had, the general consensus among investors who follow these issues appears to be: 1) that significant improvements can and should be made to the content of these disclosures; 2) that, while potential exists to reduce redundant or no longer relevant disclosures, this is a less urgent concern; and 3) that, unless the needs of investors and other leading users of financial disclosures are made its central focus, this effort could do more harm than good.

The wide-ranging Concept Release raises a number of important issues. This comment letter will focus on a relatively few, higher level issues. These include:

- the definition of materiality and how it relates to suggested enhancements to the content of required disclosures;
- what we need to know about the audience for disclosures in order to develop appropriate policies regarding the content and presentation of disclosures;
- how to weigh costs when evaluating suggestions to enhance or reduce disclosures, including proposals to further scale disclosures for smaller issuers; and
- how technological advances could be used to improve (or undermine) the effectiveness of disclosures.

[1] The Consumer Federation of America (CFA) is a non-profit association of more than 250 state, local, and national pro-consumer organizations formed in 1968 to advance the consumer interest through research, education, and advocacy.

We have chosen to focus on these issues because each, in its way, will play a significant role in determining whether the Commission's disclosure effectiveness project actually produces disclosures that better meet investors' needs and preferences.

1) The Commission must avoid an overly narrow definition of materiality.

Decisions about materiality drive the content of disclosures. As the Release explains, the Court has held 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 make an investment decision." Despite this expansive, investor-focused interpretation, some have sought to suggest that disclosures are required only if they are material to the financial condition or business operations of the company. That is far too narrow a definition of materiality on which to base determinations about Regulation S-K disclosure requirements, particularly since these disclosures inform not just investment but also voting decisions.

Our concern is that a too narrow interpretation of materiality could be used to deny proposals by "reasonable" investors to expand and update disclosures required under Regulation S-K. This is particularly true for many of the disclosures characterized as "sustainability" or ESG disclosures discussed in the Release. For example, the Release discusses suggestions to enhance disclosures regarding international tax concerns. With companies keeping trillions of dollars in profits off-shore,[2] and governments increasingly cracking down on these tax avoidance strategies, the potential for companies to take a significant financial hit if and when countries do crack down is readily apparent. Disclosures that would enable investors to assess those risks should clearly be deemed material, even if each individual aspect of the disclosure necessary to provide that complete picture of potential tax liabilities might not *by itself* be deemed material to the company's financial condition or business operations. Other issues, such as labor practices or environmental practices, are clearly related to companies' business operations and are material to investors who seek to ensure that their investments match their values. Moreover, even from a strictly financial perspective, there is a benefit to getting out ahead of issues, such as climate change risks, that management may dismiss as immaterial today, but that may later prove to have significant financial implications. The many reasonable investors who are concerned about those risks should be able to get the information they need to assess those risks.

Instead of clinging to an outdated disclosure model, the Commission should acknowledge that issues such as these are in fact material to leading users of Regulation S-K disclosures. The world has changed since the Commission decided in 1975 not to require disclosures related to environmental issues and "other matters of social concern" absent a direct congressional mandate. An entire thriving segment of the investment company market has grown up around concepts of social investment since that time. And even among investors that do not self-identify as engaged in social investment, ESG issues have grown in importance. As Ernst & Young found when it surveyed more than 200 institutional investors, "...almost two-thirds of respondents say companies do not adequately disclose information about ESG risks, and nearly 40% call for companies to do so more

---

[2] See Citizens for Tax Justice, *Fortune 500 Companies Hold a Record $2.4 Trillion Offshore*, Mar. 3, 2016, available at http://ctj.org/pdf/pre0316.pdf. The report found that profits held offshore were $2.4 trillion in 2015. Looking at just twenty-eight corporations, the report found an increase in offshore holdings of $200 billion between 2014 and 2015.

fully in the future."[3] These issues affect voting as well as investment decisions. According to an analysis by Gibson Dunn, for example, the most common 2015 shareholder proposal topics involved political and lobbying activity.[4] In the same vein, more than a million investors cared enough about political spending disclosure to write to the SEC urging rulemaking.

In each of these cases, and others raised in the Concept Release as well, there appears to be a "substantial likelihood" that "reasonable" investors would view disclosures in these areas as significantly altering the "total mix" of information available to them when making investment and voting decisions. It is not the appropriate role of the SEC to substitute its judgement about what information it is reasonable for investors to want or to restrict required disclosure based on an overly narrow definition of materiality measured exclusively by the impact on a company's financial condition or business operations. Under no circumstances should the Commission adopt an approach to disclosure that further weakens or subordinates this investor-focused concept of materiality.

2) The Commission needs to better understand the audience for Regulation S-K disclosures if it is to develop an appropriate policy response to issues raised in this Release.

As the Concept Release acknowledges, the nature of the audience for disclosures can and should drive decisions about disclosure requirements with regard both to content and to the presentation of those disclosures. Unfortunately, while a Concept Release is an effective means of canvassing the views of active participants in the regulatory process about possible alternative approaches, it is not a particularly effective means of gaining broad insights into the nature of the audience for disclosures or the information preferences of various groups. Ideally, further study of that issue should have preceded this stage of the Commissions disclosure effectiveness project, with the results of that research included in Concept Release. Such an approach would have allowed for a more informed analysis of the various proposals considered in the Release. It appears, however, that the Commission has undertaken this project without any such prior research, relying in some cases on analysis of the audience for disclosures that is decades old.

The following are among the issues the Commission needs to answer before proceeding with any radical changes to the format of Regulation S-K disclosures and before deciding to eliminate as redundant or unnecessary disclosures that a portion of the investing public may view as vitally important:

- Who are the primary users of financial and business disclosures and how do they use and analyze the information provided?
    - What are the major subsets within the larger audience for disclosures?
    - How do the information needs of the various subgroups differ?
- To what extent do retail investors use financial and business disclosures required under Regulation S-K?
    - Does their use differ from that of institutional investors and analysts? If so, how?
    - To the extent that retail investors do not use these disclosures, what inhibits their use (e.g., reliance on others for investment decisions, inaccessibility or density of

[3] Ernst & Young LLP, *Tomorrow's Investment Rules 2.0*, 2015, available at http://www.ey.com/Publication/vwLUAssets/EY-tomorrows-investment-rules-2/$FILE/EY-tomorrows-investment-rules-2.0.pdf.
[4] Gibson Dunn, *Shareholder Proposal Developments During the 2015 Proxy Season*, July 15, 2015.

the disclosures themselves, lack of sophistication necessary to evaluate the information provided, preference for other information sources)?

- Would changes in format or content increase the likelihood that retail investors would find the disclosures useful and informative?

We are not suggesting that there is a complete lack of knowledge around these issues. But there is a notable lack of data on these issues presented in the Release. So, while we can confidently assume that various different types of institutional investors, securities analysts, and credit rating agencies are among the leading users of financial and business disclosures, how confident is the Commission that it has a detailed understanding of who *all* the major users of these disclosures are, let alone what information they find valuable, what information they find to be useless or redundant, how they access and analyze disclosures, and what costs and burdens they face in accessing this information as a result of our current unwieldy disclosure apparatus? Given the lack of information on these topics presented in the Release, we have to conclude that there are significant gaps in the Commission's knowledge on these topics. Even less is known about retail investors' use of these disclosures, including whether significant numbers of retail investors use them at all and, where they do, how they prefer to access that information.

Until the Commission can answer those questions, it can't make a truly informed decision about many of questions raised in the Concept Release, particularly with regard to the format and presentation of disclosures. So, for example, when the Commission raises questions about whether it is appropriate to allow disclosures to be housed and cross-referenced between different documents, you can't answer without knowing how investors access those documents and whether they are more concerned about reducing disclosure redundancies or reducing disclosure fragmentation.

- Does anyone still use these documents in paper form, or has their use moved entirely online? If the latter is the case, then it is easier to justify approaches that allow cross-references between documents in order reduce duplication, particularly if those cross-references take the form of hyperlinks that make the information available with a single click of a mouse. [5]
- If there are still significant percentages of investors who read these documents in paper form, then preserving the ability to download the disclosures as a coherent document remains important.[6]
- Would investors, and particularly retail investors, find the disclosures more useful if they were provided with an up-front summary of the most important information?[7] Anecdotal information presented at the most recent meeting of the Investor Advisory Group suggests that it might, indicating this is an area where further study is warranted.[8]

---

[5] If the Commission does end up adopting this approach, it must also take steps to ensure that any such changes don't have the effect of reducing the liability standard for disclosures that are not directly included in the body of the document. Investors will not benefit if changes designed to reduce disclosure burdens also reduce issuers' accountability for disclosure accuracy.

[6] We are skeptical that this is the case, but the Release provides no data to support our assumption that paper disclosures in this area have become largely obsolete.

[7] And how would the Commission ensure that such an approach isn't used to draw attention away from negative information or information that the issuer may prefer to obscure?

[8] See remarks of Christoph A. Pereira at the July 14th meeting indicating that readership of General Electric reports increased significantly when they began including an executive summary.

This is just a sampling of questions that can only be answered based on a better understanding than the Commission has provided here of the information needs and preferences of key users of business and financial disclosures.

The Concept Release by itself will not be sufficient to answer those questions. Instead, getting reliable answers that reflect a detailed understanding of how investors access and analyze disclosures will require a combination of survey and focus group research and direct outreach to different types and subgroups of investors. Absent that additional research, the policy debate is likely to be won by the loudest voices in the process, which often means the issuer rather than the investor community. This tendency can already be seen assumptions underlying the Release for which no supporting evidence is offered. These include assumptions that our current disclosures are excessive, burdensome, and an impediment to small company capital formation and that investor understanding would be improved if disclosures (particularly those that issuers view as immaterial or unnecessary) were reduced.[9] Some of those assumptions may ultimately be proven to be true, but the Commission needs a firmer grounding in fact before proceeding to eliminate or reformat disclosures on the basis of untested theories. It has not provided any data to support those assumptions here.

3) **When considering costs, the Commission must look beyond just regulatory costs to issuers and also consider the effect of disclosures on the cost of capital and on the burdens investors face in retrieving information.**

Throughout the Release, the Commission discusses the need to "make tradeoffs between costs to issuers and benefits to investors" in making decisions about the content and presentation of disclosures. But the Release presents a very limited view of the costs of disclosure, focusing almost exclusively on the regulatory costs to registrants. While this is a valid consideration, it is not the only consideration. But the Commission largely ignores equally valid concerns about the costs to investors of accessing and analyzing the information contained in disclosures. Moreover, the Commission voices the concern that, "As disclosure costs rise, registrants' costs of capital may increase, which can reduce investment, lower the value of a company and impede economic growth" without providing any evidence that disclosure costs have reached a level where this might be a legitimate concern. It largely ignores extensive counter-evidence that investors tend to reward greater transparency with lower costs of capital, increasing the value of a company and promoting economic growth. As CFA Institute has noted in previous comments to the Commission, investors price in the lack of transparency, clarity and comparability in what may be perceived to be lower-quality requirements.

The Commission's one-sided view of the costs of disclosure is particularly troubling in the context of proposals to further expand the number of companies subject to scaled disclosure requirements. The Release states, for example, that the Commission "has addressed the costs of disclosure through regulatory relief in the form of scaled disclosure requirements for certain smaller registrants. These accommodations are intended to promote capital formation and provide relief where the fixed costs of compliance may be particularly high relative to the size of the company while also considering investor protection." The Release provides no evidence, however, that reducing disclosure requirements for smaller companies has been effective in promoting small

[9] This is not to suggest that there is no room to remove disclosures that are outdated, redundant, or unnecessary. Our point is: 1) that decisions about what disclosures fall into those categories should be based on a clear understanding of investors' needs and preferences and 2) that a Concept Release that will never be read by the majority of investors provides an imperfect vehicle for gaining that understanding.

company capital formation. What evidence exists that this strategy has succeeded in making additional capital available to these companies? And, if it has, what evidence exists that this has resulted in long-term, sustainable growth and job creation at these companies? There are, after all, reasons to be skeptical that reducing disclosures that investors value would be a successful strategy to encourage increased investment. As the Release itself states, the benefits of disclosure may in fact be greater for smaller registrants "because information asymmetries between investors and managers of smaller companies are typically higher than for larger, more seasoned companies with a large following." In short, the notion that scaled reporting will promote small company capital formation rests on the assumption that providing less information about companies that are already likely to be less well known to investors will make investors more willing to commit capital to those companies.

Before it doubles down on a dubious strategy of promoting capital formation by reducing transparency, the Commission should first ascertain the effect of previous steps to reduce disclosures for smaller issuers on the availability and cost of capital. Are investors comfortable with the level of disclosure provided for these smaller issuers, or does the relative lack of information discourage investment or result in an increased cost of capital? Is the cost of disclosure a genuine impediment that discourages small companies from going public? Or have other factors, including policies that have made it increasingly easy for companies to raise capital without going public, played more of a role? If disclosures are the culprit, are investors concerned that they are being deprived of appropriate investment options because onerous disclosure requirements are driving companies away from going public? Or are they satisfied to invest in these smaller companies through private offerings? Until the Commission can answer these questions, and do so in a way that lays to rest concerns about the harmful effect of reduced transparency, any expansion of the companies that qualify for scaled disclosure would be reckless and irresponsible.

4) Technological changes should be used to improve, not undermine, the effective presentation of disclosures.

When the Commission launched EDGAR, creating a centralized online database for corporate disclosures, it was at the forefront of efforts to use technology to increase market transparency. Today, we stand at a juncture where technological advances once again have the potential to transform the way we present disclosures. It is to the Commission's credit that it has undertaken an effort to update EDGAR and that it raises questions in this Concept Release that explore the potential for further advances in this area. Here again, however, we are skeptical that a concept release offers the best means to obtain expert input. Direct consultation with the technical experts who best understand what is feasible in the area of online disclosure would, in our view, produce more useful input. While some may take the time to submit comments, that is far from guaranteed. Obtaining that input before the comment process would help to ensure that this discussion occurs on the most useful and relevant terms.

As noted above, what the Commission can achieve in this area will rest in part on the degree to which use of these disclosures has moved entirely online.[10] If that transformation has occurred, then the Commission can stop thinking of these disclosures as "documents," in the sense of cohesive paper documents, and think differently about the best way to collect and compile the data that is required to be disclosed. If many or most of the major users of these disclosures use analytical

[10] We believe this transition to all online viewing of disclosures is more likely to have occurred here, in the area of corporate business and financial disclosures, than in certain areas of the retail market, such as disclosures about mutual funds. Absent actual data, however, we can only speculate.

methods that benefit from structured data, as appears to be the case, then prioritizing advances in the use of structured data and data tagging should move to the top of the list of priorities. The Commission has made admirable strides in this area in recent years, but it should continue to explore ways to reduce the costs and increase the quality of structured disclosures. On the other hand, if the Commission's analysis indicates that a significant percentage of investors continue to rely on the disclosures as documents, in the traditional way we think of that term, then that would lead the Commission to a different policy approach, unless technical experts can offer solutions that reconcile these competing needs.

One issue raised in the Release that caused us grave concern was the suggestion that the Commission might eliminate the requirement to file disclosures entirely, relying instead on the information's being made readily available on company websites. While maintaining a centralized database carries costs, the requirement to file the disclosures has to be one of the least significant costs associated with Regulation S-K disclosures. But the increased costs to investors to retrieve the resulting highly dispersed information would likely go up significantly, particularly for retail investors and less technologically sophisticated institutional investors. We urge the Commission to categorically reject any such change.

Conclusion

U.S. capital markets have thrived by promoting full and fair disclosure of material information. The Commission has an opportunity to update its disclosures to ensure that they continue to meet that standard. But it will only achieve that goal if it focuses on the needs and preferences of investors and adopts an interpretation of materiality that reflects those needs and preferences. Moreover, while this Concept Release raises a number of important questions, more can and should be done to ensure that the Commission has a comprehensive understanding of the audience for these disclosures before proceeding with proposals that are based on unsubstantiated assumptions. Only then will it have the basic information it needs to craft policies that improve the effectiveness of disclosures for the key users of those disclosures.

Respectfully submitted,

Barbara Roper
Director of Investor Protection