# SEC Investor Advisory Committee

June __, 2016

Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Re: File No. S7-06-16
Release No. 33-10064
Disclosure Effectiveness

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Ladies and Gentlemen:

As members of the Securities and Exchange Commission's Investor Advisory Committee (IAC), we appreciate the opportunity to share with you some of our preliminary views regarding your recent concept release on "Business and Financial Disclosure Required by Regulation S-K" ("Concept Release") and the Division of Corporation Finance's ("Division") broader work in the area of disclosure effectiveness (Disclosure Effectiveness Project).

Further, as you are well aware, as part of recent legislation, namely the Fixing America's Surface Transportation (FAST) Act, the Commission has been tasked by Congress to carry out a study of Regulation S-K to, among other things, determine how best to simplify disclosure requirements and evaluate methods of information delivery and presentation that discourage repetition or disclosure of immaterial information. In that connection, Congress directed the IAC's involvement in the form of a consultative process that will provide input to a report of findings and recommendations to Congress.[1] We are pleased to be involved in any way that adds value to your work, and view this letter as an integral part of the IAC's contribution.

## Overview

While recognizing substantial opportunities for improvement, the IAC is of the view that the current degree, quality and frequency of disclosure for U.S. issuers overall is appropriate and a source of strength for the U.S. capital markets. The current system greatly benefits retirees, pension funds, endowments and households that are directly and indirectly market participants. In that regard, we take great comfort from the fact that you have made it clear that merely "reducing the volume of disclosure is not our objective – we want to put better disclosure into the hands of investors."[2] We, therefore, expect that the Disclosure Effectiveness Project will find cost-effective ways to not only eliminate redundant and useless disclosure but also to increase the disclosure of areas critical to investor understanding of the financial risks associated with the companies in which they invest.

[1] *See* Section 72003(b) of the Fast Act, https://www.congress.gov/114/bills/hr22/BILLS-114hr22enr.pdf
[2] *See* https://www.sec.gov/News/Speech/Detail/Speech/1370543104412#.VDMCNRYlp-0

We understand from the Concept Release that the Division is currently focused on the non-proxy statement related requirements of Regulation S-K. While proxy-related disclosure enhancements in areas like executive compensation and corporate governance under Regulation S-K have received attention more recently than some of the other areas, that attention and even greater focus on those matters is warranted given the importance of these issues. We urge the Commission to prioritize these areas for disclosure enhancement and look forward to providing our perspectives on those matters.

**Overarching Principles**

That said, we do believe that there are a series of overarching principles that should be top of mind as they relate to the Disclosure Effectiveness Project. We believe that any changes to the current disclosure regime should be measured against the impact on the following considerations:

- Audience for Disclosure. We share the view that our current disclosure regime and any changes to it should be guided primarily by the needs of the investor community and should include a focus on material information that would be reasonably expected to have an impact on investors' ability to reasonably manage risk and make investment decisions. The density of the state of disclosure is daunting for retail investors and the Disclosure Effectiveness Project provides an opportunity to address that issue.[3] However, the reality from an overall market perspective is that the bulk of market participants do not feel that they are inundated with useless information. Consequently, proposed changes should be judged on the basis of whether they will be of greater utility to investors overall (balanced against the reporting and other costs to issuers and the risk of unintended consequences) and not primarily on whether they shorten disclosure forms or limit liability of issuers on account of misstatements or omissions. In this regard, we do not agree with changes to the existing disclosure regime that would seek to reduce the frequency of periodic reports.

- Focus on Retail Investors. At the same time, however, while U.S. capital market participants are dominated by sophisticated institutions such as mutual funds, ETFs, pension funds and hedge funds, retail investors represent an important segment of the investment public. Maintaining or even strengthening retail investors' confidence in our capital markets are important goals insofar as broader market integrity is strengthened when those who are least-well positioned from a resource and sophistication perspective can feel safe investing. Doing so does not require a reduction in the complexity or completeness of the existing disclosure regime but does require that the system of disclosure be structured in a manner that permits retail investors low-cost access to the information most relevant to their decision making process.

[3] We do not believe, however, that the current system requires disclosure of "high levels of immaterial disclosure" that results in the obscuring of "important information" or causes a reduction in "incentives by certain market participants to trade or create markets for securities." Moreover, as noted elsewhere in this letter, we believe that the primary way of addressing the needs of retail investors is to adopt a system of filing information that facilitates in a cost effective manner access to the relevant information.

- Consistency and Comparability. Investors seek information about specific issuers as they judge a company's performance, but also against other issuers in terms of where they allocate capital. Consequently, proposed changes should be judged in part as to whether they improve comparability period-over-period with respect to any given issuer as well as across issuers.

- Leveraging Technology. The Commission is in the process of developing a second generation for the Electronic Data Gathering, Analysis and Retrieval system (EDGAR). Proposed changes should be judged on the basis of whether they optimally leverage or enhance EDGAR's usability to investors. Data tagging, improved search functions, document dissemination, use of hyperlinks as cross-references, and incorporation of material from issuer websites are all areas worthy of focus. We are generally supportive of a policy that avoids duplication of information and encourages the use of cross-references.

- Redundancies. The existing system contains redundancies and superfluous required disclosures that many have already identified as opportunities for improvement. As a general guide, issuers should not be required to repeat a responsive disclosure that appears elsewhere in the same document. Similarly, repetitive disclosure from filing to filing can be reduced through hyperlinks and other mechanisms, particularly for documents filed with the Commission in a structured format.[4]

- Principles Based versus Prescriptive Disclosure Requirements. The Concept Release includes a discussion of the differences between principles and rules based disclosure. Principle based disclosure involves the imposition of a disclosure objective, often based upon the materiality of the information, while rules based disclosure is more prescriptive and provides less opportunity for managerial discretion. A critical function of Regulation S-K is to ensure a minimum degree of disclosure that facilitates comparability. As a result, Regulation S-K is and should remain primarily rules based, with the antifraud provisions and Rule 12b-20 adding a principles-based component.[5] However, we note that S-K often includes principles-based requirements, and we are not opposed to this approach.

We believe that changes to Regulation S-K should generally be measured on how they impact these general considerations. Below we outline more specific recommendations on discrete issues.

## Manner of Information Delivery

In this age of enhanced technology, we believe that any consideration of disclosure effectiveness must include consideration of the method of delivery to the Commission and the ability of investors to retrieve the filed information. We believe that all information filed with the Commission should be provided in a machine readable interactive format.

[4] We note, however, that any use of hyperlinks across filings must take into account the difficulty of investors relying on hard copies to locate the relevant disclosure.
[5] 17 CFR § 240.12b-20.

**Layering Disclosure**

Investors' accessibility to investment-related information should not be hindered by the sheer size and complexity of periodic disclosure reports. We believe usability of those reports from an investor perspective will be greatly enhanced if the Commission were to adopt a "layered" approach for disclosure that would permit issuers to provide upfront summary information regarding the key elements of disclosure within a document, without the need to repeat the full disclosure that is required elsewhere including financial statements.

Layering, however, suggests more than the use of cross references as a means of avoiding the need to repeat disclosure. Cross references and layering may also be necessary for investors to more fully understand matters discussed in the relevant filing. Thus, for example, one commenter noted that discussions of legal proceedings required by Item 3 of Form 10-K are often not cross referenced to discussions of legal proceedings in footnotes to the financial statements. Moreover, companies do not always include a table of contents in their annual reports[6] and frequently, with respect to the financial statements, fail to cross reference applicable notes.[7] The Commission should encourage the use of layering and cross-referencing where necessary to avoid repetitive disclosure and where necessary to ensure that investors can easily access all relevant information on a particular topic.

We note that some commentators have supported the idea of a "Company Profile" that involves a file at the SEC that contains core data about the business and management of the company. The goal of this approach would be to focus reports on new information about the latest fiscal period, a goal that we support. To be clear, we are not recommending the Company Profile in lieu of filing periodic reports but in addition to those reports, with cross-references permitted. This approach could improve the navigability of disclosure documents and reduce the length and scope of periodic reports.

**Entity Identification**

Disclosure effectiveness should facilitate the ability of investors and others to identify all relevant information on a company specific basis. As the Concept Release notes, Regulation S-K currently requires, as part of the exhibits, a list of subsidiaries of the registrant.[8] The provision, however, provides that the company need not disclose subsidiaries that are not significant under Regulation S-X. Disclosure documents may not, therefore, provide a complete understanding of a company's structure and leaves open the possibility of undisclosed pockets of meaningful firm-specific and systemic risk.

As discussed in the Concept Release, we believe that the Commission should require the use a global identifier such as Legal Entity Identifier (LEI) in order to facilitate the identification of the registrant, its subsidiaries and any controlled affiliates as a condition for submitting filings

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[6] *See* Annual Report on Form 10-K, The JW Smucker Co., June 25, 2015, https://www.sec.gov/Archives/edgar/data/91419/000119312515235197/d918672d10k.htm

[7] *See* Letter from William J. Klein, Esq., and Thomas J. Amy, Esq., to the Division of Corporation Finance, August 31, 2015, available at https://www.sec.gov/comments/disclosure-effectiveness/disclosureeffectiveness-52.pdf

[8] *See* Item 601(b)(21).

into EDGAR.[9] Such a system could greatly facilitate the work of the Commission and other prudential regulators related to systemic risk, firm interconnectivity and managing the stress of leverage at broker-dealers, asset managers and other market participants. Likewise the requirement would benefit investors trying to understand complex structures employed by some firms.

The requirement should not, as the Concept Release asks, be limited to financial firms. Many non-financial firms have complex structures that bear the hallmarks of financial firms such as those in the real estate sector, asset managers and commodity-related businesses with significant financing and hedging activities. The SEC should require, in the appropriate circumstances, that registrants make the list of identified entities easily accessible to regulators, investors and market professionals.

**Structured Data and Quality**

In the current disclosure regime, the Commission has taken significant strides in increasing the information submitted in a structured format, particularly in newly created forms. The adoption of both Regulation A+ and Regulation Crowdfunding included online fillable forms that submits information to the SEC in a structured format. The Division of Economic and Risk Analysis has made available financial statement data sets consisting of XBRL data filed with the Commission.[10]

More needs to be done both in the short and long term to ensure that information filed in periodic reports (and proxy statements) is delivered to the SEC in a structured format. We strongly urge the Division to accelerate the development and implementation of Inline XBRL so that filers may file only a single document with the required tagged data. In addition, however, as the IAC recommended in 2013, the Commission should create a "plan to convert information filed with the SEC into tagged data."[11] The Disclosure Effectiveness and the EDGAR Reimaging Project provide an opportunity to take this step.

In addition, however, the Division, as part of disclosure effectiveness, should take steps to increase the quality of the data filed with the SEC. Filings already undergo analytical validation as part of the filing process. The rules used to screen filings could be altered to ensure improved data quality. In addition, the Division could issue more letters to CFOs on common errors made in connection with XBRL/XML compliance[12] and staff bulletins and notices that place filers on notice of common errors. We strongly recommend that, as part of disclosure effectiveness, the Division make clear the importance of data quality and take additional steps to ensure increased quality of the data submitted to the Commission.

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[9] *See* http://www.leiroc.org/. While supportive of general goals of the LEI system, a minority of the Committee members believe that more study is advisable as to costs and benefits before the Committee mandates that all registrants be subject to LEI designation. To the extent that the Commission is not yet prepared to mandate LEI designation among registrants it should consider undertaking a study regarding the feasibility and merit of such a system as well as the Commission's authority under the securities laws to tie EDGAR access to LEI designation.

[10] https://www.sec.gov/dera/data/financial-statement-data-sets.html

[11] https://www.sec.gov/spotlight/investor-advisory-committee-2012/data-tagging-resolution-72513.pdf

[12] The Division did so, for example, in July 2014. *See* https://www.sec.gov/divisions/corpfin/guidance/xbrl-calculation-0714.htm

**EDGAR and Accessibility**

Currently, the Commission has underway the Edgar Redesign. Under the oversight of the Office of Strategic Initiatives, the Edgar Redesign has been described as "[a] multi-year initiative to develop the next generation electronic disclosure system."[13] We further understand that the Division is participating in the Redesign.

The Redesign, coupled with the goal of disclosure effectiveness, provides an opportunity to rethink the system of filing and retrieving information with the Commission. In the short term, investors would benefit from changes to the system that permitted such standard functions as the ability to have natural language and Boolean search capabilities within an issuer's filings as well as across issuers.[14]

Longer term, consideration should be given to a more complete revision of the approach to filing and retrieving information. In that regard, we note that the 21st Century Report issued in 2009[15] recommended, among other things, that:

- Disclosure information and other data should be submitted and stored in an interactive format.
- The Commission should consider establishing a data warehouse, with a principles-based framework for managing the data.
- The Commission should consider providing for multiple submission methods for disclosures.

While we do not have specific recommendations on these issues at this stage, we encourage the Division to consider the broader issues raised in the 21st Century Report. We further believe that the Commission should seek comments on this issue as part of any effort to affirmatively obtain more and better feedback from investors and others in the market.

**Specific Disclosure Issues**

In addition to the discussion of "overarching principles" and the "manner of delivery," we include comments on a number of specific items addressed in the Concept Release. This section does not reflect all of the issues or areas identified by members of the Committee. Instead, they involve discrete issues.

- Non-GAAP Financial Disclosure. Non-GAAP financial disclosure can help investors evaluate issuers. However, Non-GAAP financial disclosure has become an area of

[13] https://www.sec.gov/osi
[14] Indeed, Chair White noted in testimony that the Commission intended on "making incremental enhancements to the existing [Edgar] system to improve the user experience, accommodate new submission requirements, and other improvements that are needed prior to the full redesign." "https://www.sec.gov/news/testimony/testimony-white-sec-fy-2017-budget-request.html
[15] *See* https://www.sec.gov/spotlight/disclosureinitiative/report.pdf

increasing concern.[16] Under Regulation G, Non-GAAP financial measures disclosed outside of Commission filings must be accompanied by certain specified disclosures, including the most comparable GAAP measure and a reconciliation with GAAP. When the Non-GAAP measures are included in an SEC filing, Item 10(e) of Regulation S-K requires significant additional disclosure including a statement disclosing the reasons why management believes that the Non-GAAP measures provide useful information to investors, and, if material, the purpose of using a Non-GAAP financial measure. In addition, Item 10(e) requires that the comparable GAAP measure be included "with equal or greater prominence." The Committee believes that the Commission should take steps in this area to ensure that Non-GAAP financial measures are not used in a manner that conveys an inaccurate perspective on a company's operations. This could include a requirement that the measures be reviewed by a company's outside auditor and that the "equal or greater prominence" requirement should be added to the disclosure of Non-GAAP financial measures when appearing outside of SEC filings.[17]

- Public Policy and Sustainability Matters. The Concept Release states that the Commission has, in the past declined to require "disclosure relating to environmental and other matters of social concern" including political spending absent additional congressional mandate or unless "such matters are material." Nonetheless, the Release asks for feedback on "which, if any, sustainability and public policy disclosures are important to an understanding of a registrant's business and financial condition and whether there are considerations that make these disclosures important to investment and voting decisions." It is clear that a significant, and growing number, of investors utilize sustainability and other public policy disclosures to better understand a company's long-term risk profile.[18] The Committee believes that environmental, social and governance issues should be subject to the same materiality standards as other sources of risk and return under the Commission's rules. Like other sources of business risk and return, environmental, social and governance issues can be material based on a quantitative measure such as the expenditures required or the effect on earnings. Such issues can be material when considered in the context of qualitative factors such as the effect on a company's reputation[19] or the impact on the purchasing decisions of the issuer's customers. Likewise these matters can impact voting decisions by shareholders. However, the Commission does not have well-developed guidance to issuers in the area

[16] *See* Hans Hoogervorst, Chairman, International Accounting Standards Board Venue: Annual Conference of the European Accounting Association, Maastricht, May 11, 2016, available at http://www.ifrs.org/About-us/IASB/Members/Documents/Hans-Hoogervorst-EAA-Annual-Conference-11-May-2016.pdf

[17] A minority of Committee members noted that, as a result of the Instructions to Item 2.02 of Form 8-K, earnings releases are already required to satisfy the "equal or greater prominence" requirement. Therefore, these Committee members questioned whether the Committee's proposal would create burdens and discourage useful disclosure in other settings, such as presentations at investor conferences, without sufficient benefit for investors.

[18] For example, the UN Principles for Responsible Investment includes 1,500 signatories who collectively manage assets of more than US$60 trillion. These signatories commit to, *inter alia*, incorporate environmental, social and governance factors into their investment decision-making, https://unpri.org/about

[19] The Commission has noted this possibility in vague terms. *See* Exchange Act Release No. 61469 (Feb. 12, 2010) ("Another example of a potential indirect risk from climate change that would need to be considered for risk factor disclosure is the impact on a registrant's reputation. Depending on the nature of a registrant's business and its sensitivity to public opinion, a registrant may have to consider whether the public's perception of any publicly available data relating to its greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.").

of assessing qualitative factors in this area similar to Staff Accounting Bulletin No. 99.[20] . The Committee recommends the Commission develop an analytical framework that more clearly sets out the qualitative factors that can affect the analysis in this area and other per se disclosure. [21]

- Stock Repurchases. While some disclosure of repurchases is already mandated by Item 703 of Regulation S-K, this requirement does not result in the identification of information that many investors would likely find material. This would include the source of the funds, the impact on corporate indebtedness, the relation between the amounts spent on buybacks and reinvestment and the decision-making and governance processes that guide capital expenditures.[22] Whether through amendments to Item 702 or additional staff guidance, these matters should be subject to disclosure.

- MD&A and Materiality. Item 303 of Regulation S-K requires in some cases the disclosure of forward-looking information including known trends and uncertainties. The test provides that disclosure need not occur if the relevant trend "is not reasonably likely to occur." To the extent that management cannot make this determination, disclosure is required "unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur." The Concept Release asks whether the test should be replaced by the "probability/magnitude" test approved by the Supreme Court in *Basic v. Levinson*, a standard that would raise the threshold for disclosure.[23] We believe that the current two step test employed by the Commission provides the appropriate standard and should not be changed to a higher threshold.

- International Tax Issues. The Concept Release noted that companies often disclose that "changes to U.S. and non-U.S. tax law could adversely affect their anticipated financial position and that "foreign tax rates and treaties, may have a material impact on a registrant's operations." The Concept Release asks for comments on whether issuers should be required to "describe foreign regulations that affect their business." A description of foreign regulatory risks could be useful to investors. The Committee recommends additional steps be taken to ensure issuers disclose relevant, information regarding the material components of issuers' tax strategies, any material risks accompanying those strategies, the sustainability of issuers' effective tax rates and the degree to which current tax planning may obscure longer-term tax risk. [24] The Committee

[20] SEC Staff Accounting Bulletin No. 99 Aug. 12, 1999); https://www.sec.gov/interps/account/sab99.htm
[21] A minority of Committee members expressed concern that changes to the Commission's disclosure rules or new qualitative guidance could be used to advance political or social issues that those members believe are better suited for Congress or other federal authorities. These Committee members believe that the current disclosure regime's focus on, and definition of materiality, already provides an appropriate framework to analyze these issues.
[22] This issue was discussed at length in one letter submitted to the Commission. *See* Letter from William J. Klein, Esq., and Thomas J. Amy, Esq., to the Division of Corporation Finance, May 12, 2015, available at https://www.sec.gov/comments/disclosure-effectiveness/disclosureeffectiveness-42.pdf
[23] As the Concept Release noted: "The Commission has also stated that this 'reasonably likely' standard is a lower threshold than 'more likely than not.'"
[24] A minority of the Committee expressed concern that, under some circumstances, tax-related mandated disclosure would exacerbate the risk of adverse tax consequences to the determinant of issuers and their investors without sufficient countervailing benefits. They also expressed concern that additional rules in this area, such as country-by-country reporting, could yield vast amounts of information that would be of little utility to investors

further felt that the Commission should take steps to ensure that its disclosure requirements keep pace with evolving international standards in the area of country by country tax reporting.

**Generating More and Better Investor Feedback**

Despite avoiding areas like executive compensation and corporate governance, the Concept Release is voluminous and broad ranging. We believe that the need for meaningful feedback on all of the issues raised in the release will be substantial. We urge the Commission to convene focus groups and generally extend invitations for feedback from specific market participations. Many will not have views on every issue, but the Commission and Staff ought to be able to benefit from feedback received in the course of verbal question and answer sessions and not only through written comment letters.

Moreover, the Concept Release rightfully seeks comment on the mechanisms that would facilitate the ability to respond to "market developments" in assessing and refining the system of disclosure. We urge the Division consider instituting a more formal system for obtaining continuous feedback in connection with the existing disclosure regime. Issuers, investors and other market participants should be encouraged to raise issues in real time when they confront gaps in the disclosure system under real-life circumstances. In addition, however, the staff should engage in outreach on a regular basis in an effort to obtain feedback on disclosure issues as they arise. Greater use of data analytics to pinpoint areas of concern would likely be a useful source of feedback. As a general rule, however, we do not believe that "sunset" provisions are an appropriate mechanism for addressing concerns over market developments.

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We appreciate the Division's incredibly hard work on the Disclosure Effectiveness Project, which has literally been years in the making. We hope to have a chance to share our perspectives with you in person and certainly answer any questions you may have.

Sincerely,