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# ESSENTIAL INFORMATION:

MODERNIZING  
OUR CORPORATE  
DISCLOSURE SYSTEM



CENTER FOR CAPITAL MARKETS  
COMPETITIVENESS

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

### EXECUTIVE SUMMARY

For more than eight decades, materiality has been the lodestar of the public company disclosure regime under the federal securities laws. The longstanding materiality standard—namely, what is important to a reasonable investor focused on investment returns—has instilled in investors and issuers alike a confidence in the accuracy and integrity of information that promotes market efficiency, competition, liquidity, and price discovery. Materiality serves as a constant, regardless of who chairs the Securities and Exchange Commission (SEC), which party occupies the White House, or other political or policy shifts. In short, materiality is a bedrock of the U.S. public capital markets and has long been interpreted to ensure that federal securities regulation and the SEC remain faithful to the SEC’s mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.

Materiality strikes a balance that advances the interests of return-seeking investors who have capital to deploy and issuers who seek capital to expand their businesses, innovate, and create jobs. In order to access the most liquid, transparent, and deepest public capital markets the world has ever known, a company must disclose material information to the investing public so that investors can make informed decisions. Both the courts and the SEC have kept materiality appropriately bounded—centering materiality on what reasonable investors need to assess an investment opportunity—thus safeguarding the federal securities laws’ mandatory disclosure regime from being co-opted to serve social or political agendas.

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In recent years, however, a variety of groups have zeroed in on SEC disclosures by pressing for new mandatory disclosure requirements to advocate for social and political change. For example, calls continue for public companies to disclose more concerning climate change, environmental impacts, political spending, social policy, and management of their internal affairs, routinely with the objective of advancing a goal extraneous to the SEC’s mission. These topics are often referred to by the acronym “ESG” for environmental, social, and governance issues; sometimes the terms “sustainability” or “socially oriented investing” are also used.

Many groups advocating an ESG agenda seek to reconceptualize materiality to advance their own objectives and in so doing depart from the traditional conception of materiality as laid out by the Supreme Court, lower courts, and the SEC. An investor that bases its voting and investment decisions on promoting social or political goals is not a “reasonable” investor when it comes to what materiality means under



the federal securities laws. Rather, the test of investor reasonableness is that an investor focuses on the financial and operational performance of companies as the investor attempts to accumulate wealth and earn income by committing capital. This formulation of reasonableness helps ensure that what is disclosed is tied to advancing the goals of the federal securities laws, as reflected in the SEC's mission. It also shields the federal securities laws and the SEC from being politicized and avoids putting the SEC in the position of regulating outside its expertise.

The question of what information is (and is not) material to the reasonable investor is vitally important to our capital markets' success for another reason. Investors need important information when evaluating a company's business with an eye on making a good investment decision. At the same time, a system in which an issuer must disclose every bit of information that an investor could potentially want to know would undoubtedly swamp investors with unnecessary and often confusing information.<sup>1</sup> An effective disclosure regime provides investors the material information they need to make objective decisions regarding the value of an investment, but does not overwhelm them with peripheral information that can obscure what is material and distract investors from what really matters about a company. As Justice Thurgood Marshall explained in the landmark case *TSC Industries v. Northway (TSC)*, "[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 decisionmaking."<sup>2</sup>

Moreover, the weighty burden of preparing such all-inclusive SEC disclosure documents would further discourage companies from going public and thus exacerbate the steady decline in the number of public companies that the United States has experienced over the past twenty years. This is particularly so when costly disclosures are not important to assessing a company's financial and operational performance in searching for the best investment returns. The competitiveness of the U.S. capital markets, in other words, depends on getting materiality right.

The guiding principle for public company disclosure is, *and should remain*, materiality, as that term has long been defined with reference to the *reasonable investor*, whose primary goal is to earn a return on capital. To avoid any confusion, we do not advocate for public companies to stop producing the kind of material financial and operational information that investors have traditionally received. Nor are we saying that ESG information is never material to evaluating and understanding

<sup>1</sup> Center for Capital Markets Competitiveness, *Corporate Disclosure Effectiveness: Ensuring a Balanced System That Informs and Protects Investors and Facilitates Capital Formation* (July 2014), available at <https://www.uschamber.com/press-release/us-chamber-releases-recommendations-sec-corporate-disclosure-reform>.

<sup>2</sup> 426 U.S. 438, 448-49 (1976).

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

a company and its business. What we are saying is that public companies should not be mandated under the federal securities laws to disclose information that is not material to a reasonable investor. Efforts to advance social or political goals through SEC-mandated corporate disclosures risk eroding investor confidence in the integrity of securities regulation and impairing the competitiveness of the U.S. capital markets, thereby making it more costly for innovative companies to raise capital and working directly against the best interests of investors.

Accordingly, the public company disclosure regime is emphatically the wrong means for trying to address geopolitical issues, advancing a particular social policy, or pushing other policy objectives that are extraneous to the SEC's mission. Investors, issuers, and our capital markets are best served by a disclosure system based on the well-established definition of materiality that focuses on the reasonable investor's interest in investment returns.

## A BRIEF HISTORY OF MATERIALITY

In 1975, the SEC described its views on materiality:

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. . . . [C]ertain types of disclosure might be so voluminous as to render disclosure documents as a whole significantly less readable and, thus, less-useful to investors generally. In addition, disclosure to serve the needs or desires of limited segments of the investing public, even if otherwise desirable, may be inappropriate, since the cost to registrants, which must ultimately be borne by their shareholders, would be likely to outweigh the resulting benefits to most investors.

In administering the disclosure process under the Securities Act and the Securities Exchange Act, the Commission has generally resolved these various competing considerations by requiring disclosure only of such information as the Commission believes is important to the reasonable investor—material information. This limitation is believed necessary in order to insure meaningful and useful disclosure documents of benefit to most investors without unreasonable costs to registrants and their shareholders.<sup>3</sup>

The Supreme Court's landmark decision on materiality came in 1976 in *TSC Industries, Inc. v. Northway, Inc.*<sup>4</sup> On behalf of a unanimous Court, Justice Marshall, the opinion's author, rejected the idea that a fact is material if it "might" be important to an investor. Instead, the Court explained that in formulating a materiality standard, it sought to avoid a scenario in which investors would be overwhelmed "in an avalanche of trivial information—a result that is hardly

<sup>3</sup> Environmental and Social Disclosure, Securities Act Release No. 5,627, Exchange Act Release No. 11,733, 40 Fed. Reg. 51,656, 51,659-70 (Oct. 16, 1975).

<sup>4</sup> 426 U.S. 438 (1976).



conducive to informed decisionmaking.”<sup>5</sup> Justice Marshall recognized that information overload harms investors, and therefore set a more demanding test of materiality. Specifically, under *TSC*, information is material if “there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”<sup>6</sup> For avoidance of doubt, Justice Marshall provided an alternative formulation, famously declaring that in order to be material, “there must be a 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 made available.”<sup>7</sup>

The Supreme Court set “substantial likelihood” as the test of materiality precisely because it is more demanding than “might.” The Court opted to protect investors from being flooded with information and refused a lower materiality threshold that would have required companies to disclose anything that any investor might be interested in. The thrust of the Court’s opinion is that materiality is to be judged through the eyes of a “reasonable shareholder.” This orients materiality toward an investor’s effort to understand and evaluate a business when making an investment or voting decision as compared with being oriented toward some other type of decision or purpose that disclosure could serve.

*TSC* informs the disclosure obligations of public companies under the federal securities laws, and, even when lower courts do not explicitly cite the opinion, it is still the precedent behind all judicial decisions on materiality. Furthermore, the SEC itself regularly cites to and otherwise relies on *TSC* as controlling authority.<sup>8</sup>

The Supreme Court also addressed materiality in 1988 with *Basic, Inc. v. Levinson* (*Basic*),<sup>9</sup> another bedrock case in the Court’s securities regulation jurisprudence. In that case, the Court considered the materiality of information in the context of preliminary corporate merger discussions and forward-looking (or speculative) information about the future as compared with current or historical facts. The Court

<sup>5</sup> *Id.* at 448-49.

<sup>6</sup> *Id.* at 449.

<sup>7</sup> *Id.* at 449.

<sup>8</sup> See, e.g., Business and Financial Disclosure Required by Regulation S-K, Securities Act Release No. 10,064, Exchange Act Release No. 77,599, 81 Fed. Reg. 23,916 at 23,926 (Apr. 22, 2016); SEC, Div. of Corp. Fin., CF Disclosure Guidance: Topic No. 2, Cybersecurity (Oct. 13, 2011); Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9,106, Exchange Act Release No. 61,469, 75 Fed. Reg. 6,290 at 6,292 (Feb. 8, 2010); Commission Guidance on the Use of Company Websites, Exchange Act Release No. 58,288, Investment Company Act Release No. 28,351, 73 Fed. Reg. 45,862 at 45,869 (Aug. 7, 2008).

The SEC generally interprets its rules in a manner consistent with the Supreme Court’s jurisprudence. For example, SEC Rule 405 under the Securities Act of 1933 and Rule 12b-2 under the Securities Exchange Act of 1934 define materiality as relating to those matters where “there is a substantial likelihood that a reasonable investor would attach importance in determining whether to” buy or sell the subject securities.

<sup>9</sup> 485 U.S. 224 (1988).

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

began by making it clear that the *TSC* materiality construct applies not just to voting decisions as were at issue in *TSC*, but also to decisions to buy, sell, or hold a security. The Court noted that materiality depends on the specific facts of a given situation, which gives materiality some flexibility. Accordingly, the Court adopted a balancing test for forward-looking information that requires one to weigh the probability that an event, such as a potential transaction, will occur against the magnitude of the event. Importantly, the Supreme Court reiterated that materiality depends on the significance a reasonable investor would place on the information. And the Court emphasized the role of the materiality requirement in filtering out “essentially useless information that a reasonable investor would not consider significant, even as part of a larger ‘mix’ of factors to consider” in making an investment decision.<sup>10</sup>

From the foundational cases of *TSC* and *Basic*, we jump to 2011. In the 2011 decision of *Matrixx Initiatives, Inc. v. Siracusano*,<sup>11</sup> the Supreme Court explained that materiality is a fact-based inquiry and held that the materiality of a pharmaceutical company’s non-disclosure of adverse event reports concerning its product does not necessarily depend on whether there is statistically significant evidence that the product causes a health risk; adverse event reports may be material without a showing of statistical significance. Notably, the Court continued to apply the objective “reasonable investor” test of materiality from *TSC* and *Basic* and discussed materiality in the context of the “trading decision” of an investor, just as the Court had done in *Basic*. Materiality is still about arming reasonable investors with the significant information they need to understand and evaluate a business so that they can make informed investment or voting decisions with an eye toward investment returns.<sup>12</sup>

The courts have told us more about the reasonable investor. According to the Supreme Court, one should not ascribe “child-like simplicity” to the reasonable

<sup>10</sup> *Id.* at 234 (citing *TSC*, 426 U.S. 438 (1976) at 448-49).

<sup>11</sup> 563 U.S. 27 (2011).

<sup>12</sup> Courts recognize that reasonable investors care not only about a company’s quantitative disclosures, such as a company’s financial statements, but also about qualitative disclosures on the enterprise and its financial and operational performance. Accordingly, qualitative information may be material if it meets the test of materiality that is described in this paper.

Regarding qualitative disclosures, attention often focuses on SEC Staff Accounting Bulletin No. 99 (SAB 99). SAB 99 provides interpretive guidance from the SEC staff applying materiality to financial statements and related financial disclosures. In SAB 99, the staff sought to move away from strict numerical thresholds for determining materiality. For example, one common rule of thumb developed using a 5% threshold for materiality. A misstatement or omission of a financial statement item, such as revenue or net income, that was under 5% would not be material for disclosure purposes; a misstatement or omission greater than this benchmark would be considered material.

With SAB 99, the SEC staff stated that companies may not conclude the materiality of a financial misstatement based solely on a quantitative benchmark. A numerical threshold may be used as an initial step in assessing materiality, but companies must also analyze the alleged misstatement using qualitative factors. In the staff’s view, information that falls below the 5% threshold may be material to a reasonable investor. Put in terms of *TSC*, even information that fails a 5% test could significantly alter the “total mix” of information. Among other things, SAB 99 singles out for consideration whether a misstatement is intentional by management, whether a misstatement turns a loss into a profit at the company, whether a misstatement conceals an unlawful transaction, whether a misstatement affects the company’s compliance with regulatory obligations, and whether a misstatement relates to a particularly important part of the company’s business.



investor.<sup>13</sup> To the contrary, lower courts have indicated that reasonable investors are presumed to be able to complete basic mathematical calculations, to have familiarity with the basic operation of a securities margin account, to understand the time value of money and basic principles of diversification, to know that free cash and securities may be used to earn interest, to be able to read and understand risk factors and other disclosures plainly presented in a prospectus, to “grasp the probabilistic significance” of merger negotiations, and generally to be aware of macroeconomic conditions.<sup>14</sup> The fact that courts have referenced these characteristics of a reasonable investor is no surprise; it further indicates that materiality centers on the financial and operational performance of companies and on investment returns for investors.

More importantly, “reasonableness,” for purposes of materiality, takes on a particular meaning that is tied to the SEC’s mission. It is to be interpreted in light of what the federal securities laws were designed to achieve. Reasonableness, therefore, is not just another way of describing an investor’s rationality, sensibleness, and sound judgment. Rather, reasonableness turns on why an investor views information as important in the first place. Specifically, a reasonable investor is one that focuses on investment returns—that is, that prioritizes the financial and operational performance of a company as compared with other considerations. Stated differently, an investor that bases its voting and investment decisions on promoting social or political goals is not a reasonable investor for purposes of determining the materiality of information under the federal securities laws, even if that investor’s perspective is rational, sensible, and sound when it comes to that investor’s non-financial motivations. This remains so notwithstanding that an investor, in seeking to advance a special interest or a social goal, rallies like-minded individuals to the cause. Just because a topic, such as climate change, campaign finance reform, or war in the Democratic Republic of the Congo, may be of social or political significance, that in and of itself does not make it material under the federal securities laws.

Finally, the materiality inquiry does not center on a single investor or even a limited segment of investors; materiality does not turn on the wants or needs of investors with an idiosyncratic point of view. Indeed, a corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact.<sup>15</sup> If the rule were otherwise, disclosure documents would endlessly expand

<sup>13</sup> 485 U.S. 234 (1988).

<sup>14</sup> See, e.g., *In re Merck & Co., Inc. Securities Litigation*, 432 F.3d 261, 270 (3d Cir. 2005); *Levitin v. PaineWebber, Inc.*, 159 F.3d 698, 702 (2d Cir. 1997); *In re Donald J. Trump Casino Securities Litigation*, 7 F.3d 357, 371-77 (3d Cir. 1993); *Dodds v. Cigna Securities, Inc.*, 12 F.3d 346, 351 (2d Cir. 1993); *Flamm v. Eberstadt*, 814 F.2d 1169, 1175 (7th Cir. 1987); *Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984); *Ash v. LFE Corp.*, 525 F.2d 215, 219 (3d Cir. 1975).

<sup>15</sup> See, e.g., *In re Time Warner, Inc. Securities Litigation*, 9 F.3d 259, 267 (2d Cir. 1993).

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

with each investor's claim for more information. The rule as it is mitigates the risk that SEC disclosure documents will become too dense and impenetrable for investors by seeking to be all things to all people. It also helps ensure that the SEC, in fashioning and enforcing the disclosure regime under the federal securities laws, emphasizes what is best for investors overall and adheres to the agency's mission as the country's capital markets regulator.

Applying materiality as a filter when determining the limits of mandatory disclosure is a critical component of the regulation of the capital markets. It imposes some measure of order on the total mix of information available to investors. Under-disclosure may provide investors with an inadequate basis for making investment and voting decisions. On the other hand, over-disclosure, particularly when it includes trivial information or information that investors generally would not find useful, contributes to the avalanche-of-information problem that Justice Marshall warned against and that the Supreme Court sought to protect investors from. When the SEC burdens the materiality standard by requiring disclosure of matters of limited interest or to achieve goals outside the SEC's mission, it risks doing a disservice to the very investors it is charged with protecting. A definition of materiality that depends on what a reasonable investor seeking investment returns would find important filters out information that special interests—such as those looking to promote social or political goals by changing a company's business practices, executive compensation, or corporate governance—might like to know.

**Over-disclosure contributes to the avalanche-of-information problem that Justice Marshall warned against.**

In sum, the time-tested formulation of materiality discussed above helps ensure that the SEC, in fashioning and enforcing the mandatory disclosure regime, does what is best for investors overall and adheres to the agency's mission as the country's capital markets regulator.

## WHY MATERIALITY MATTERS

In recent years, public companies have been increasingly pressured to provide more information about topics other than their financial performance, operations, and strategy. The pressure for more ESG disclosure, for example, has taken the form of shareholder proposals; shareholder litigation; exhortation by legislators and regulators; and advocacy efforts to encourage the SEC, Congress, and state legislatures to adopt new mandatory ESG reporting requirements. Numerous



public companies have voluntarily chosen to disclose ESG information to the public, primarily through separate sustainability reports or other communications, such as press releases, websites, conferences, and social media postings, as well as through SEC filings.

Civil society organizations, socially oriented investors, and other groups have begun publishing their preferred methodologies for ESG reporting. Some groups advocate far-reaching ESG disclosures that they would apply to a wide range of enterprises across virtually all sectors on topics such as board makeup, political spending, labor practices, greenhouse gas emissions, and supply chain management. Other groups are more focused, advocating for detailed sustainability metrics that are industry specific and that are said to be most relevant to particular stakeholders in those industries, including certain investors in those industries.

A multitude of materiality formulations now widely circulate from ESG groups, separate and apart from the one that *TSC* and *Basic* teach. Notwithstanding their differences, the various approaches to materiality that ESG proponents push all lead toward a common endpoint: requiring public companies to make additional disclosures concerning sustainability and other ESG topics. Each of these approaches to ESG disclosure expands the scope of materiality under the federal securities laws, such as by considering disclosure from the viewpoint of a wide range of stakeholders other than the reasonable investor, by using disclosure to advance social or political goals outside the SEC's mission, or by developing specific disclosure metrics that go well beyond what the courts or the SEC have endorsed in assessing materiality. Indeed, portions of the target audience may own no securities at all. Whatever each ESG proponent's exact purpose and intentions might be, the effect would be to change what materiality means.

While public companies are always free to disclose ESG information on a voluntary basis—in fact, it has become commonplace for companies of all sizes to publish sustainability reports outside their SEC filings—some policymakers, non-governmental organizations, and private-sector groups have zeroed in on public company disclosure documents filed with the SEC as a preferred place to include new mandatory disclosures on a wide range of ESG topics. Whether these proposed new mandatory disclosures seek to reveal material information to the reasonable investor for purposes of the federal securities laws and are consistent with the SEC's mission is very much a matter of debate.

No matter the topic or the merit of the proposed disclosure's objective, the Supreme Court's traditional materiality standard should be the benchmark as

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

the SEC and other policymakers consider whether to impose new disclosure obligations on reporting companies; the federal securities laws should not be used to mandate that public companies disclose information that does not pass this test. To be clear, this is not about prohibiting companies from making more ESG disclosures if they elect to, nor is it about persuading companies to scale back what they already disclose. Rather, it is about the proper materiality threshold for *mandating* that public companies disclose more than is presently required. Indeed, those companies for which sustainability and other ESG information is material, as materiality is understood under *TSC* and *Basic*, already would have to disclose it.

Here is why adhering to the traditional conception of materiality under the federal securities laws matters:

### The SEC Should Steer Clear of Special Interest Disclosure

SEC-mandated disclosures should not be used to further social or political motivations that the federal securities laws were not designed to advance. The SEC disclosure regime should not be an avenue for special interests to impose their agenda on shareholders at large, particularly when doing so does not maximize long-term value creation at a company. The objective of many calling for new public company ESG disclosures is not the enhancement of shareholder value, but rather achieving some social impact, political goal, or personal gain. These goals, if met, would in many cases contribute to an environment that makes it more difficult for businesses to innovate, compete, and grow.

**SEC-mandated disclosures should not be used to further social or political motivations that the federal securities laws were not designed to advance.**

Using the federal securities laws to affect corporate behavior is itself not new, but the increased frequency and the expanded breadth of recent calls for new disclosures that are aimed at social or political goals or at serving the unique interests of an unrepresentative subset of investors or even non-investors is a departure from historical practice. Simply put, the federal securities laws should not be used as a cudgel to force public companies to disclose immaterial information that is unrelated to the SEC's mission. Nor should disclosure of immaterial information be required when the goal is to end-run state corporate law by trying to change governance structures and practices or reconfigure the duties of directors and officers who, under state law, are charged with maximizing the value of the enterprise for shareholders. Disclosures made under these circumstances come at the expense of investors as a whole.



More than that, special interest disclosures risk politicizing the federal securities laws and the SEC and foster regulatory uncertainty that is detrimental to investors and businesses alike. To the extent securities regulation becomes an instrument of social or political change, it becomes unmoored from its longstanding purposes as reflected in the SEC's mission. In turn, the bounds within which securities regulation is fashioned become porous if not wiped away, which in turn facilitates political and other types of opportunism. The federal securities laws—and thus the SEC as the body that crafts, administers, and enforces the regulatory regime—become fair game to be used however those with the most influence would like.

In a world in which those with power in government can drive the direction of federal securities regulation, the social and political agendas shaping securities regulation would likely vacillate between philosophical extremes, creating regulatory instability. Stated more bluntly, if materiality were to veer from the traditional conception of it, the federal securities laws would be up for grabs for progressives and conservatives—depending on who is in power at any particular moment—to use these laws to serve their preferred social and political goals. This exacerbates the kind of unpredictability that chills investment and prudent risk-taking, stifles entrepreneurship and innovation, and is a drag on growth and job creation. It also undercuts the integrity and credibility of the SEC by creating the impression, if not the reality, that the agency is heavily politicized. The SEC as an institution would be irreparably harmed if the public were to perceive the agency as shifting back and forth between social and political agendas every time there is a new party in the White House.

### Policymakers Should Avoid Mandating Disclosure Outside the SEC's Expertise

The SEC's expertise centers on the operation, practices, and regulation of securities markets. The agency is not an expert about topics outside its mission, such as how to resolve difficult issues of a social or political nature. The SEC is not well positioned, for example, to address concerns relating to things like supply chain management, the environment, labor relations, the political process, and foreign affairs. While the agency's 80-plus years as a capital markets regulator does well to position it to address emerging and persistent issues in that arena, the SEC understandably struggles when asked to craft disclosures that are designed to achieve goals other than protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.

The recent experience with the "conflict minerals" disclosure rule required by the Dodd-Frank Act should give ESG proponents pause. The mandated disclosure failed to provide investors with material information and, by many accounts, has made the

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

situation in the Democratic Republic of the Congo worse.<sup>16</sup> Indeed, in overturning the rule, the D.C. Circuit Court of Appeals concluded that claims that the rule would help were “pure speculation,”<sup>17</sup> recognizing that the SEC did not try to quantify or otherwise substantiate any benefits. The court held that the disclosure requirement violated the First Amendment because it was not adequately shown that the compelled speech would further the government’s humanitarian goals.

The SEC’s expertise is not implicated simply because disclosure is involved. It is implicated only when the goals of the disclosure are within the scope of the SEC’s mission. Asking the agency to act beyond its mission creates the unacceptable risk that the SEC, if it takes up the call, will unintentionally do more harm than good because it does not have the capability to appropriately assess the disclosure’s costs and benefits. Goals outside the SEC’s mission should be left to other governmental bodies, civil society organizations, and the private sector to address by means other than the federal securities laws.

### Policymakers Should Be Wary of Information Overload

Justice Marshall’s concern about the “avalanche of information” has proved prophetic. In the 40 years since *TSC* was decided, SEC disclosure documents have become substantially lengthier, much denser, and noticeably more complicated. While the SEC has launched a “disclosure effectiveness” initiative over the past few years to revisit the current federal securities law disclosure system, the fact remains that reading and digesting many SEC reports is more difficult and time consuming than it should be.<sup>18</sup> The basic problem of information overload is that investors will overlook useful information when inundated with so much.<sup>19</sup>

To have an effective disclosure regime that promotes transparency and the interests of investors and our capital markets, we must be wary of information overload; we certainly cannot exacerbate the problem. Illustrating the point, in 2015 researchers at Stanford University, along with their coauthors, released a study of institutional

<sup>16</sup> See, e.g., Sudarsan Raghavan, *How a Well-Intentioned U.S. Law Left Congolese Miners Jobless*, *The Washington Post*, Nov. 30, 2014; David Aronson, Op-Ed, *How Congress Devastated Congo*, *The New York Times*, Aug. 7, 2011.

<sup>17</sup> See, e.g., *Nat’l Ass’n of Mfrs. v. SEC*, 800 F.3d 518, 525 (D.C. Cir. 2015).

<sup>18</sup> See Business and Financial Disclosure Required by Regulation S-K, Securities Act Release No. 10,064, Exchange Act Release No. 77,599, 81 Fed. Reg. 23,916 at 23,919 (Apr. 22, 2016). See also Keith Higgins, Director, Division of Corporation Finance, U.S. Securities & Exchange Commission, “Disclosure Effectiveness,” Remarks Before the American Bar Association Business Law Section Spring Meeting (Apr. 11, 2014), available at <https://www.sec.gov/News/Speech/Detail/Speech/1370541479332>.

<sup>19</sup> In 2014, the Chamber released a report that made over a dozen recommendations to address the overload issues and provide for more effective disclosures. See Center for Capital Markets Competitiveness, *Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation* (July 2014), available at <https://www.uschamber.com/press-release/us-chamber-releases-recommendations-sec-corporate-disclosure-reform>.



investors controlling over \$17 trillion in assets. The study found that 55% of investors believe the corporate proxy statement is too long and that only a third of the information is relevant.<sup>20</sup> The study also found that 48% of surveyed investors believe that a typical proxy is difficult to read and understand. On average, these investors claim to read only 32% of a typical proxy statement.<sup>21</sup>

Not surprisingly, investors often voice their disapproval with the current SEC disclosure regime as they encounter needlessly voluminous and complicated SEC filings. With this in mind, judging materiality through the eyes of a reasonable investor is essential because it reduces the risk that disclosure documents will continue ballooning based on the almost endless unique or personal interests expressed by special interests and their supporters to make a social or political impact that is not related to the SEC's mission.

### Policymakers Should Be Sensitive to Lack of Investor Interest

A corollary to the information overload problem is the concern that unwarranted disclosure will result in public company filings that are laden with information that is immaterial to investors, making the documents themselves less useful to investors. The SEC's well-intentioned effort over the past 10 years to expand the executive compensation disclosures that public companies must make is a case in point.

The executive compensation disclosure requirements are complex and result in public company disclosures that often run 30 pages or more, which are impenetrable to even many sophisticated readers. Many reasonable investors, finding the so-called "Compensation Discussion and Analysis" narrative tedious or unintelligible, simply skip over it altogether or at least ignore large portions of it. Few would argue that robust disclosure about the compensation of executive officers and members of the board of directors is not material. But by compelling companies to accompany material compensation information with many immaterial details, the value of the decision-useful information is diluted or obscured by being associated with disclosures in which most investors have little to no interest.

Just because a particular topic is of interest, it does not follow that every detail about that topic is important to the reasonable investor. Before imposing further disclosure obligations on public companies, policymakers should weigh whether the precise

<sup>20</sup> David F. Larcker et al., Stanford Univ., 2015 Investor Survey: Deconstructing Proxy Statements—What Matters to Investors 1 (Feb. 2015), available at [https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-surveyey-2015-deconstructing-proxy-statements\\_0.pdf](https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-surveyey-2015-deconstructing-proxy-statements_0.pdf).

<sup>21</sup> *Id.*

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

incremental disclosure is itself important in light of the total mix of other available information. If the proposed disclosure gets at a minor point or does not have a sufficiently high likelihood of helping reasonable investors better understand and evaluate a business, a balancing of the equities weighs against imposing the additional disclosure requirement.

### The SEC Should Apply Rigorous Economic Analysis Before Mandating Any New Disclosure

The SEC cannot proceed with any rulemaking to mandate new disclosure unless it satisfies its legally mandated cost-benefit analysis. SEC rulemakings must meet various requirements under the federal securities laws, including the SEC's obligation to consider whether an action is necessary or appropriate in the public interest; protects investors; and will promote efficiency, competition, and capital formation.<sup>22</sup> Moreover, the SEC may not adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the federal securities laws.<sup>23</sup> The Administrative Procedure Act requires that an agency action be invalidated when it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."<sup>24</sup> A rule that is not the product of a reasoned determination by the regulator—such as a rulemaking that does not properly take into account both the costs and the benefits—runs afoul of the Administrative Procedure Act as arbitrary and capricious.<sup>25</sup> These rulemaking requirements serve the commonsense goal of trying to ensure that a rule is not adopted if it will do more harm than good as measured against the SEC's mission.

Courts have invalidated an SEC rule when the agency has failed to evaluate the rule's full effects, including its economic implications. Thus, when deciding whether to mandate a new disclosure, the SEC must weigh whether the alleged benefits of the new disclosure are outweighed by its potential costs. These costs are not limited to the out-of-pocket financial costs of collecting raw data, preparing new narratives to include in SEC filings, and paying outside counsel or other advisors to vet the work product.

Changes in mandated disclosure influence corporate behavior by influencing how individuals themselves behave. These behavioral changes are not always for the better, notwithstanding the regulator's best intentions, and thus may be a cost of any rule change. For instance, some mandatory disclosure obligations might lead

<sup>22</sup> 15 U.S.C. § 78c(f) (2006)

<sup>23</sup> 15 U.S.C. § 78w(a)(2) (2006).

<sup>24</sup> 5 U.S.C. § 706(2)(A) (2006).

<sup>25</sup> See generally *Metlife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016), *argued*, No. 16-5086 (D.C. Cir. Oct. 24, 2016).



to forgone business opportunities, less entrepreneurial risk-taking, and forgone capital formation as unnecessarily burdensome disclosure demands discourage or make unavailable certain financing opportunities. Others may exacerbate the problem of excessive short-termism in corporate decision-making by focusing investors on near-term results. While requiring quarterly financial reports for public companies serves the important purpose of promoting corporate transparency, it also can encourage some companies to focus unduly on hitting quarterly earnings targets at the expense of long-term growth. These examples illustrate the kinds of costs that the SEC must consider as part of any rulemaking to impose new disclosure mandates on public companies. In addition, the exercise of preparing new disclosures can itself take valuable energy and attention away from more productive business priorities; the opportunity cost of time and effort, therefore, is yet another cost that the SEC must account for before requiring new disclosures. Costs like these are particularly unjustified if incurred in exchange for advancing a special interest or social or political agenda outside the SEC's mission.

In recent years, parties have more frequently challenged SEC rulemakings in court on the grounds that the agency conducted a faulty cost-benefit analysis by ignoring costs. These challenges have met with notable success, as federal courts have overturned a number of SEC rules. Any rulemaking that seeks to mandate the disclosure of costly or immaterial information, or information that is untethered from the SEC's mission, could mire the SEC in yet more unnecessary litigation. Policymakers, including the SEC, need to calibrate the costs and benefits of disclosure by limiting disclosure mandates to truly material information under the Supreme Court's, as well as the SEC's, traditional conception of materiality rooted in TSC and Basic.

### Ineffective Disclosure Harms the Competitiveness of U.S. Capital Markets

The U.S. capital markets have been the envy of the world. The U.S. has fostered the world's most favorable environment for investing and accessing entrepreneurial capital, in part by shaping a regulatory regime that did not overburden businesses searching for the funding they need to innovate and expand. Companies and investors alike have been attracted to the U.S. markets, understanding that they would be participating in markets that are transparent, efficient, and well regulated.

Even before the financial crisis, the U.S. Chamber of Commerce and many other organizations warned of the need for fundamental regulatory reform to ensure the long-term vibrancy and competitiveness of our domestic capital markets and our economy. Since 1996, the number of public companies has decreased by almost

# ESSENTIAL INFORMATION:

## MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM

40%, and the current number of public companies is little more than in 1982, when the economy was less than half its current size.<sup>26</sup> The issue facing policymakers is how to ensure that the U.S. promotes fair and efficient capital markets that can provide the resources for businesses to compete and for consumers to have the affordable, accessible, and fair financial products that they need.

Left unchecked, ineffective disclosure will further hasten the steady decline in the number of private companies seeking public listings in the U.S., which over the longer term impairs economic growth. Founders of successful enterprises will not relish the prospect of preparing lengthy disclosures on topics unrelated to the core business once the initial public offering is completed, especially when the goal of the disclosures is to “name and shame” directors and officers or advance social or political goals that are extraneous to the business’s financial and operational success. Foreign issuers, already wary of seeking a U.S. listing due to the U.S. litigation environment, have yet another reason to steer clear of American capital markets. Simply put, over-disclosure—in that public companies are mandated to disclose information that is not material to a reasonable investor—provides further disincentives to taking a company public and imposes costs on investors that do not share the social or political agenda that is being pushed.

A disclosure regime that keeps focused on delivering actionable material information that is important to reasonable investors trying to maximize the value of their investments will yield immediate benefits. Capital should be allocated more efficiently, market discipline and corporate governance should improve, and the costs and burdens companies incur when raising capital should ease. Emerging growth companies—those newer and smaller entrepreneurial businesses that are a vital source of innovation and job creation in the United States—especially stand to benefit along with the individuals and institutions investing in them.

### WHY MATERIALITY MATTERS

- The SEC Should Steer Clear of Special Interest Disclosure
- Policymakers Should Avoid Mandating Disclosure Outside the SEC’s Expertise
- Policymakers Should Be Wary of Information Overload
- Policymakers Should Be Sensitive to Lack of Investor Interest
- The SEC Should Apply Rigorous Economic Analysis Before Mandating Any New Disclosure
- Ineffective Disclosure Harms the Competitiveness of U.S. Capital Markets

<sup>26</sup> Maureen Farrell, *America’s Roster of Public Companies Is Shrinking Before Our Eyes*, Wall St. J., Jan. 4, 2017.



## CONCLUSION

Through most of its history, the SEC has avoided politically charged issues and has been able to pursue its tripartite mission without being pressured to pursue a social or political agenda outside its expertise. In fact, just recently, the SEC affirmed the following:

The Commission . . . has determined in the past that disclosures relating to environmental and other matters of social concern should not be required of all registrants unless appropriate to further a specific congressional mandate or unless, under the particular facts and circumstances, such matters are material.<sup>27</sup>

To the extent more partisan issues are assigned to it, to the extent more demands are placed on it to serve causes other than the purposes behind the federal securities laws, and to the extent the agency wades more deeply into social debates over which there is widespread division within the public at large, the SEC itself is likely to become more politicized. In light of recent controversial rulemaking efforts, the perception of the SEC has shifted, and the agency is now at times seen as already increasingly politicized, at least as compared with the SEC's historical standing.

As an independent administrative agency, this state of affairs risks inflicting long-term reputational harm on the SEC, threatening its very credibility and independence, while at the same time impairing the competitiveness of the U.S. capital markets. Saddling the SEC with mandates to develop new rules based on politically charged topics that are unrelated to its mission will only exacerbate the situation. Conversely, focusing the agency's efforts toward disclosures that are important to reasonable investors can help the SEC navigate the shoals of controversy and steer clear of mandating disclosures that do more harm than good. Adhering to the traditional conception of materiality under the federal securities laws is the lynchpin.

<sup>27</sup> Business and Financial Disclosure Required by Regulation S-K, Securities Act Release No. 10,064, Exchange Act Release No. 77,599, 81 Fed. Reg. 23,916 at 23,970 (Apr. 22, 2016).



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