Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

June 25, 2019

Securities Disclosure: Background and Policy Issues

Disclosure requirements are the cornerstone of federal securities regulation. One of the key federal securities laws, the Securities Act of 1933 (P.L. 73-22), is often referred to as the "truth in securities" law. As this name suggests, the 1933 act focuses on disclosure, specifically requiring companies offering securities, such as stocks or bonds, for public sale to provide truthful information about these securities and the risks associated with investing in them. Similarly, the Securities Exchange Act of 1934 (P.L. 73-291), requires companies with publicly traded securities to periodically report certain information on an ongoing basis. The disclosure-based regulatory philosophy is consistent with Supreme Court Justice Louis Brandeis's famous quote, "sunlight is said to be the best of disinfectants; electric light the most efficient policeman." In practice, transparency through disclosure seeks to inform investors and policymakers and enables market mechanisms to price risk and deter fraud. This In Focus provides background on the Securities and Exchange Commission's (SEC's) disclosure regime and analyzes selected relevant policy issues.

Background

The SEC is the primary regulator overseeing the securities markets, including enforcing securities disclosure requirements. The SEC requires issuers offering and selling securities to either register with the SEC and comply with disclosure requirements (i.e., *public offerings*), or obtain an exemption from certain registration requirements (i.e., *private offerings*). The SEC also requires issuers to make certain nonpublic disclosures. For more details, see CRS Report R45221, *Capital Markets, Securities Offerings, and Related Policy Issues*, by Eva Su.

Public Disclosure

Public disclosures are publicly accessible through the SEC's online portals. When companies fundraise through public securities offerings, the SEC requires that the companies disclose certain information, including financial statements, business risks and prospects, a description of the stock to be offered for sale, and the management team and their compensation. **Table 1** lists three types of forms that the SEC requires publicly traded companies to file periodically and as major events occur.

Table 1. Examples of Public Company Disclosure

Form	Content
10-K	*Annual reports* of a company's business and financial conditions and audited financial statements.
10-Q	*Quarterly reports* for the first three fiscal quarters of the year that include a company's unaudited financial statements and financial conditions.
8-K	*Current reports* to announce major events shareholders should know about.

Source: CRS.

Nonpublic SEC-Only Disclosure

The SEC also requires companies to make certain nonpublic, SEC-only disclosures, which allow the SEC to monitor risks and inform certain research, while keeping the information confidential. The SEC normally does not make nonpublic information identifiable to any particular registrant, although it could release certain information in the aggregate and use the information in enforcement actions.

Principles of SEC Disclosure Requirements

In remarks to the SEC Investor Advisory Committee on February 6, 2019, SEC Chair Jay Clayton summarized five principles in which he believes the SEC's disclosure requirements must be rooted:

- **Materiality**—In 1976, the Supreme Court in *TSC Industries, Inc. v. Northway, Inc*. defined information as material if "there is a substantial likelihood that a reasonable shareholder would consider [the information] important in deciding how to vote."
- **Comparability**—standardized financial reporting requirements.
- **Flexibility**—the view that requirements that are too rigid can lead to "superfluous, and in some cases, misleading disclosure."
- **Efficiency**—generally, finding the rule that is "most effective with the least cost."
- **Responsibility** (or liability)—the view that rules have little long-term value if they cannot be effectively enforced.

Materiality is one of the most important principles governing public securities disclosure. In general, federal securities laws require that issuers disclose to investors all material information they need to make sound investment decisions. Federal securities laws provide that investors harmed by misleading statements or the omission of material facts can seek a remedy through litigation. To be effective, securities disclosures would neither be so restrictive that they omit essential information, nor be so voluminous that they create information overload or exhaust resources with irrelevant information.

The concept of materiality has posed challenges for regulators and companies, as it can be difficult to apply consistent standards at the individual company level in some circumstances. The SEC affords some discretion to companies through a principles-based approach to materiality, which provides some flexibility for companies to make decisions on what to disclose on a case-by-case basis. Nevertheless, the lack of a "bright line" about what exactly must be disclosed across all situations can present challenges for both investors and companies. From a regulatory perspective, it is difficult, if not impossible, to provide a clear rule as to what information might be material in all situations. As such, companies may struggle at times in determining what to disclose.

Policy Issues

This section discusses several selected ongoing policy debates over securities disclosure. Some characterize the central issue as striking a balance between requiring disclosure that is consistently material and useful on the one hand, and that can be provided in a cost-effective and justified manner on the other.

Disclosure content. Policy debates often relate to the *content* of securities disclosures. For example, attention has recently focused on what types of disclosures companies should make related to environmental, social, and governance (ESG) issues, particularly workers' rights and diversity. Thus, several proposals discussed in the 116th Congress would require a public company to disclose, for example, its total number of domestic and foreign employees; human capital management; executive and nonexecutive pay raises; policies on whether executives bear the costs of company fines; board diversity (H.R. 3279 and H.R. 1018); cybersecurity (S. 592); and financial relationships with firearms or ammunitions activities (H.R. 2364).

Disclosure quality and information overload. As disclosure requirements and related costs have generally increased over time, questions have arisen over whether disclosed information is readable and understandable to investors. For example, Walmart's initial public offering (IPO) prospectus in 1970 totaled fewer than 30 pages, compared with Uber's 2019 IPO filing of around 420 pages. Current policy debates question whether the current disclosure regime leads to *information overload*—that is, whether the high volume of disclosure makes it difficult for investors to find the most relevant information. The SEC has launched recent initiatives to simplify disclosure, for example, issuing a final rule regarding "Disclosure Update and Simplification," effective November 15, 2018.

Disclosure frequency. Policy debates have also focused on how frequently public companies are required to file reports with the SEC. The frequency of reporting could affect investors' access to information as well as companies' ongoing compliance costs. In the 115th Congress, bills were introduced that would have directed the SEC to study the costs and benefits of 10-Q quarterly reporting, especially to smaller issuers (S. 488 and H.R. 5970). Proponents of reducing the frequency of quarterly reporting argue that in addition to the costs involved, it distracts from companies' longer-term strategies. Opponents of reduction are concerned about potential negative effects on financial transparency and investor protection. In December 2018, the SEC issued a request for public comment on the nature and timing of 10-Q reporting.

Disclosure requirements for smaller firms. Some question whether disclosure requirements should be the same or different for firms of different sizes and with varying capabilities to absorb compliance costs. The IPO Task Force, an independent group of financial professionals, estimated that, in 2011, public companies spent an average of about $2.5 million to comply with SEC disclosure and other IPO compliance requirements, with annual ongoing compliance costs of $1.5 million per company. Reports suggest that such high costs disadvantage smaller companies. The Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106), enacted in 2012, reduced disclosure requirements for certain types of securities offerings. However, concerns exist that smaller companies continue to face challenges in accessing capital. To address these concerns, Congress has considered numerous legislative proposals to further customize disclosure requirements for offerings of different sizes and purposes, with some proposals building on existing JOBS Act provisions. The most notable of these proposals was the JOBS and Investor Confidence Act of 2018 (JOBS Act 3.0; House amended S. 488 in 115th Congress).

Disclosure style and format. Investors' preferences for disclosure may differ depending on whether they are retail or institutional investors. One important trend in the asset management industry relates to how investors have shifted from investing directly for themselves to investing indirectly through the use of institutional money managers. Because the current investor base is mostly institutional, some argue that the SEC's disclosure requirements should move toward data standardization and machine readability. Others argue that public disclosure should be in plain English for retail investors. In the 116th Congress, the SEC Disclosure Effectiveness Testing Act (H.R. 1815) would require the SEC, when developing rules and regulations about disclosures to retail investors, to conduct investor testing, including a survey and interviews of retail investors.

Disclosure delivery method. A final policy question concerns whether securities disclosure materials should be distributed digitally or on paper by default. After long-standing policy debate, in 2018, the SEC adopted Rule 30e-3 to allow certain investment funds to transmit shareholder reports digitally as the default option. Opponents, including the paper industry, voiced concerns that the rule disadvantages elderly and rural investors, who they argue are more accustomed to paper reading and may have less access to the internet. Supporters highlighted the environmental and economic benefits, including that the Investment Company Institute estimated the move would save $2 billion in printing and mail costs over a 10-year period, and they would like to see such digital-first options applied more broadly.

Eva Su, esu@crs.loc.gov, 7-1121

IF11256