BETTER MARKETS

October 22, 2019

Mrs. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Modernization of Regulation S-K Items 101, 103 and 105 (Release Nos. 33–10668; 34–86614; File No. S7–11–19)

Dear Secretary Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned rule proposal ("Release") published for public comment by the Securities and Exchange Commission ("SEC" or "Commission"). The Release[2] proposes to "modernize and simplify the description of business (Item 101), legal proceedings (Item 103), and risk factor (Item 105) disclosure requirements in Regulation S–K."[3] The Commission explains that "[t]he proposed amendments are intended to update our rules to account for developments since their adoption or last amendment, to improve these disclosures for investors, and to simplify compliance efforts for registrants."[4] The Proposal also reflects an emphasis on adopting a more principles-based approach to investor disclosure requirements, in lieu of more detailed, prescriptive requirements.

SUMMARY

Securities regulation is at its core a disclosure regime. Its bedrock premise is that reporting companies must disclose publicly and in a timely fashion all material information investors needs to make informed decisions. Our securities laws and the rules by which we administer them have been built on that foundation. While the specific of this Release are not significantly concerning, we believe the underpinning regulatory approach—that of giving issuers more flexibility in deciding what to disclose for their investors—can impact the availability, quality, completeness,

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 *See* Modernization of Regulation S-K Items 101, 103, and 105. Nos. Release Nos. 33–10668; 34–86614; File No. S7–11–19, 84 Fed. Reg. 44358 (August 23, 2019) *available* at https://www.federalregister.gov/documents/2019/08/23/2019-17410/modernization-of-regulation-s-k-items-101-103-and-105.

3 *See* Release at 44377.

4 *See* Release at 44358.

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and timeliness of material information that investors (and all those who serve investors, including analyst, journalists, academics, etc.) need to make more informed investment decisions. As we detail in the appropriate section below, investor, particularly, retail investors, fare better when they have access to high quality information that our current regulatory regime mandates.

Below, we offer comments that:

- Reiterate our concerns that the fundamental rationale for the Release remains subject to question; that the Commission could better utilize its finite regulatory attention by moving away from mythical notions of "information overload;"

- As a general governing regulatory approach, the Commission should maintain principles-based regulation with specific disclosure requirements that make data comparable, consistent and user-friendly;

- The Commission must require detailed human capital disclosures, and;

- While the Commission's proposal to amend Risk Factors disclosure may be a good public policy, the Commission would do better by investors by requiring detailed Environmental, Social, and Governance Disclosures as part of Risk Factors.

COMMENTS

**The Fundamental Rationale For the Proposal Remains Subject to Question.**

Better Markets and other investor advocates have long questioned the fundamental premise of the so-called Disclosure Effectiveness Initiative. For example, in our comment letter to the Commission in 2016, we raised serious concerns about the need and justification for such a review, absent persuasive evidence that investors were ill-served by the current disclosure requirements.[5] For example, as we explained, the SEC's comprehensive review of disclosure requirements goes far beyond the limited disclosure review prescribed by the JOBS ACT and is an inappropriate use of agency resources; the Commission has failed to provide any evidence that a disclosure effectiveness review is needed; the fundamental premise "disclosure overload" (which was present then in the Disclosure Effectiveness Initiative and seems to have permeated in this Release as well), is flawed and remains unsupported by credible evidence.

Nothing in the Release resolves these troubling underlying concerns.[6] Moreover, elements of the Proposal actually exacerbate those concerns. While the Proposal identifies some reasonable goals, including updating the disclosure requirements and improving them for investors, it also reflects a concern with, among other things, "simplifying compliance" and "reducing burdens" on

5 *See* Better Markets Comment Letter on Business and Financial Disclosure Required by Regulation S-K; Concept Release (RIN 3235-AL78), *available* at https://www.sec.gov/comments/s7-06-16/s70616-312.pdf incorporated as if fully set for herein.

6 At best, the Release cites comment letters that were filed in response to the 2016 Concept Release, which themselves do not seem to offer evidence that investors are demanding these changes, or that there is in-fact a problem of information/disclosure overload.

issuers. Reducing the burdens on the regulated industry is not the SEC's mission, and pursuing that goal is affirmatively inappropriate unless investors are fully and equally well-served under any set of less burdensome requirements, particularly when there is no basis for the self-interested claims of unidentified "burdens." After all, every rule can be characterized as a "burden." That makeweight argument simply cannot be a regulatory guidepost or cognizable objection when the statutory mandate is the protection of investors via a robust disclosure regime.

In addition, the Proposal emphasizes a pronounced shift toward principles-based requirements, which vest management with substantial and unwarranted discretion in determining what, for example, is material and worthy of disclosure to investors. This general approach to regulation, standing alone, is usually just a different way to pursue de-regulation at worst or industry-friendly, but investor-unfriendly regulation at best.

Taken together, these aspects of the Proposal aggravate rather than mitigate the most troubling aspects of the Commission's entire undertaking and approach. As it pursues reforms in the area of disclosure, the Commission's overriding objective must be increasing the breadth, accuracy, accessibility, and utility of disclosure, for the benefit of investors. That must be its guiding "principle."

**<u>The Commission Should Maintain Principles-Based Regulation With Specific Disclosure Requirements that Make Data Comparable, Consistent and User-Friendly.</u>**

Principles-based disclosure regimes risk giving executives undue discretion over disclosure decisions, whereas specific line-item disclosure requirements offer investors consistent and comparable data. The optimal approach is a combination of the two.

The Release characterizes the nature of principles-based prescriptive regulation as follows:

> Some of these requirements provide registrants with the flexibility to determine the disclosure that is material to an investment decision. These disclosure requirements are often referred to as ''principles-based'' because they articulate a disclosure concept rather than a specific line-item requirement. Principles-based rules **rely on a registrant's management to evaluate the significance of information** in the context of the registrant's overall business and financial circumstances and to determine whether disclosure is necessary. As the Commission stated in the Concept Release, emphasizing principles-based disclosure may allow a registrant to more effectively tailor its disclosure to provide the information about its specific business and financial condition that is material to an investment decision and in turn may reduce the amount of disclosure that may be irrelevant, outdated or immaterial. In contrast, some line-item requirements in Regulation S–K employ bright-line, quantitative thresholds to specify when disclosure is required, or require all registrants to disclose the same type of information. These requirements are sometimes referred to as ''prescriptive'' disclosure requirements because they do not rely on management's judgment to determine when disclosure is required. The

> benefits of prescriptive disclosure requirements can include comparability, consistency, and ease in determining when information must be disclosed.[7]

What's missing from this synopsis is a frank acknowledgement of the underlying danger that principles-based regulation poses: Precisely because it affords management such enormous discretion in determining what information should be disclosed to investors, it increases the likelihood that management will not disclose or withhold material information from investors or make it difficult to for them to access and understand, where the disclosure of that information might reflect negatively on a company's operations, business model, or management.

To be sure, broad regulatory principles can help define the general nature of the topics and information that disclosure must address, and the Release reflects some improvements in this regard. For example, it summarizes some of the proposed changes as follows:

- Include, as a disclosure topic, human capital resources, including any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant's business; and

- Refocus the regulatory compliance requirement by including material government regulations, not just environmental laws, as a topic.

But to be effective, such principles must be accompanied by two additional essential ingredients.

First, even as to the formulation of general principles, merely identifying topics is far too "principles-based" and woefully insufficient. The "principles" must articulate not only general topics bus also substantive standards against which the fundamental sufficiency of any disclosure can be judged. For example, it would be wholly insufficient if a rule were simply to require financial advisers to address the **topic** of the standards of loyalty and prudence they owe to their clients, without also establishing the essential yardstick to which they must always adhere: that the adviser must always act in the best interest of their client. Similarly here, simply providing that issuers must address, as a disclosure topic, "human capital resources," is insufficient even within the realm of principles-based regulation. It must do more.

With properly framed general principles in place, issuers will have clear guidance for compliance and regulators can hold firms accountable under a wide variety of circumstances, including attempts at evasion. That is the virtue of principles-based regulation that serves as a counterweight to its dangerous faith in the discretion of management.

Second, along with properly-framed principles, regulation must include detailed and specific requirements, to ensure that minimum standards apply—standards that management cannot ignore in the exercise of its discretion. As stated in the Release, this approach offers the concrete benefits of ensuring comparability and consistency in the realm of investor disclosure;

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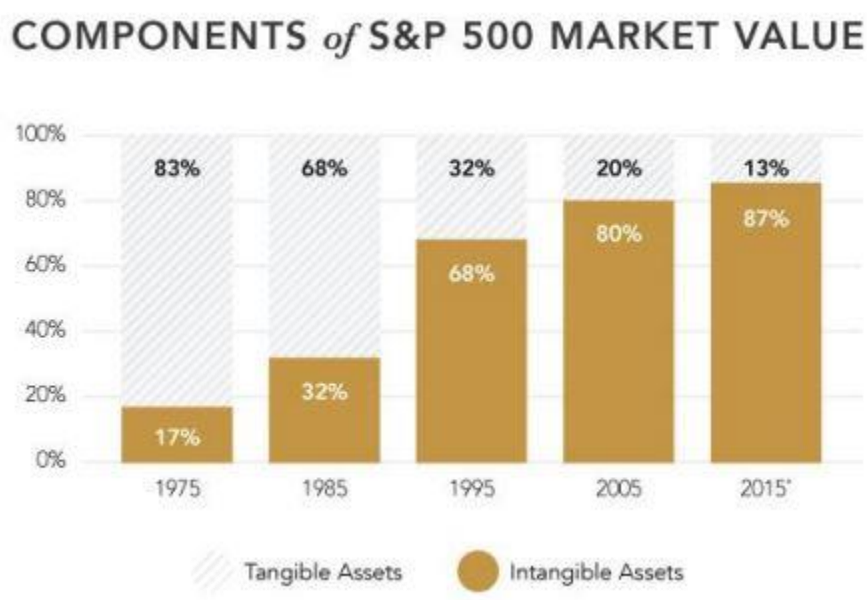
[7] *See* Release at 44359.

and as the Release also acknowledges, it provides clear guidance for "determining when information must be disclosed."[8] In other words, prescriptive requirements ensure minimum levels of disclosure regardless of whatever impulses management may have that would frustrate full and honest disclosure to investors.

**<u>The Commission Must Require Detailed Human Capital Disclosures.</u>**

The Commission is proposing to replace the current requirement that issuers disclose the number of employees with a "requirement to disclose a description of the registrant's human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant's business."[9] We support this proposal.

We also agree with the Investor Advisory Committee that found that "today's companies are increasingly dependent on their workforces as a source of value creation. Indeed, for many of the most dynamic companies, human capital is their primary source of value."[10] As shown by the chart below, today's companies' intrinsic value lies not in its assets (*i.e.*, plants, equipment, inventory, etc.) but with its intangible assets, such as educated and happy workforce.




Source: IAC Recommendations, Figure 1.

Finally, we agree with Commissioners Jackson and Lee that "investors representing trillions of dollars … have urged the SEC to require specific, detailed disclosures reflecting the

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8 *See* Release at 44359.

9 *See* Release at 44381.

10 *See* "Recommendation of the Investor Advisory Committee Human Capital Management Disclosure," (March 28, 2019), *available* at https://www.sec.gov/spotlight/investor-advisorycommittee- 2012/human-capital-disclosurerecommendation.pdf ("IAC Recommendations").

importance of human capital management to the bottom line."[11] We therefore urge the Commission to improve upon the Release and require more detailed disclosures regarding human capital.

**The Commission's Proposal to Amend Risk Factors Disclosure is Good Public-Policy But the Commission Must Require Detailed Environmental, Social, and Governance Disclosures as Part of Risk Factors.**

The Commission is proposing to require a summary of Risk Factors under Item 105, if the proceeding "Risk Factor Section" exceeds 15 pages.[12] We support this requirement but urge the Commission to lower the 15 pages-long threshold to a level that is supported by investor-tested thresholds. We urge the Commission to conduct investor-testing to determine the appropriate level to set this threshold. We would want to remind the Commission that more than 50% of investors who receive issuers' mandated annual reports do not read them, and nearly 60% of the investors who do not read these reports claim that they do not do so because either these reports are "Too complicated/hard to understand" or are "too long/wordy."[13] Therefore, the Commission should determine these thresholds based on investor-testing and empirical evidence, and not guesses.

Additionally, there is at least one other study that, using online brokerage firms' data, concluded that "individual investors invest in firms with more concise, readable, and transparent financial disclosures," an individual investors' "shareholdings increase in the quality of firms' financial disclosures," and that "individuals' shareholdings reflect a greater preference for higher financial disclosure quality relative to institutions' shareholdings."[14] Said differently, retail investors fare better when they invest in companies with quality disclosures that are concise and readable, and the benefits of readable and user-friendly disclosures matter more to individual investors than to institutional (*i.e.*, sophisticated investors).

Once the Commission determines this appropriate page-count through investor testing, then it should require (as proposed) a summary discussion for any Risk Factor disclosure that is longer (in terms of word-count or page-count) than the threshold. We agree with the Commission that investors and analysts would benefit from a summary description, which would benefit readability of the remaining discussion and make the disclosure document more user-friendly.

The Commission is also proposing to require registrants to organize risk factors under relevant headings. We also support this requirement. This will make the disclosure more accessible, user-friendly, and, ultimately aid the readability of the disclosure, and help investors to make more informed investment decisions. Finally, we also support replacing the phrase "Most Significant" with "material" factors. We believe, this change would focus issuers on disclosure

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[11] *See* "Joint Statement of Commissioners Robert J. Jackson, Jr., and Allison Herren Lee on Proposed Changes to Regulation S-K," (August 27, 2019), *available* at https://www.sec.gov/news/public-statement/statement-jackson-lee-082719.

[12] *See* Release at 44,375.

[13] *See* "Mandatory Disclosure Documents Telephone Survey," (July 30, 2008), p.12-14. A*vailable* at https://www.sec.gov/pdf/disclosuredocs.pdf.

[14] *See* "Individual Investors and Financial Disclosure," Alastair Lawrence, 56 J. Acct. & Econ., 130-147 (2013).

matters that reasonable investors would attach the necessary importance in making investment decisions.

Notwithstanding our support of Commission's abovementioned proposed matters, we believe the Commission is missing an opportunity to better fulfill its mission of investor protection. Today's investors demand detailed, comparable, consistent, machine-readable data on environmental, social and governance ("ESG") related costs and risks current issuers face. The ESG is a set of standards for a company's operations that investors use to screen investments. Environmental criteria look at how a company interacts with the natural environment in terms of risks and opportunities. Social criteria examine how a company manages relationships with its employees, suppliers, customers and the communities where it operates. Governance deals with a company's leadership, executive pay, audits and internal controls, and shareholder rights.[15] Corporations and investors see different value in disclosing ESG data: corporations are focused on growth, while investors are focused on risk.

Today, over 80% of public corporations voluntarily disclose some ESG data, and yet only 29% of investors are confident in the quality of the ESG information they are receiving. This is a perfect example how disparate disclosures that lack standards, quality controls, consistency and comparable, as is the case with the current voluntary industry practices, create uncertainty and knowledge asymmetry in financial markets.

Beyond the structural and regulatory need for harmonization, disclosure of ESG factors has the potential to drastically decrease inherent systemic risk in any marketplace by ensuring boards and executives commit time, thought, and resources to long-term value and risk factors when making decisions. For example, when credit risk that is driven by climate policy or poor governance is allowed to continue unidentified and unmanaged, this could concentrate in banks' and investors' lending portfolios and create a systemic risk to financial stability. ESG disclosure would address these risks by eliminating a lack of knowledge and informational asymmetry surrounding risks of all kinds.

Another serious governance issue, cybersecurity, has rapidly become one of the most important aspects of material disclosure. Mandating disclosure of cybersecurity risk, as already called for by Better Markets in the form of "Equifax Rule," would both encourage companies to think about threats to their systems, as well as giving the investing public and consumers valuable information to anticipate risk.[16]

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[15] The controversies surrounding Uber's recent IPO and that precipitated the recent withdrawal of the registration statement for WeWork are good illustrations of the materiality of such disclosure to investors. However, the changed circumstances at those companies only happened because of their high profile and the intense amount of media and investor interest. Most offerings don't receive any such attention and, therefore, the SEC's mandated disclosure is of paramount importance given management's incentive to omit, understate or gloss over such key issues.

[16] *See* Better Markets Press Release "The SEC Should Immediately Adopt an "Equifax Rule": Require Companies to Promptly Disclose Any Significant Computer Hack" September 26, 2019, *available* at https://bettermarkets.com/newsroom/sec-should-immediately-adopt-equifax-rule-require-companies-promptly-disclose-any.

We therefore urge the Commission to heed the calls of millions of investors who invest trillions in the US markets, fueling jobs, economic growth and capital formation, to earnestly begin the process of requiring the disclosure of comparable, consistent and high-quality ESG data.

CONCLUSION

We hope our comments are helpful to the Commission as it deliberates this proposal and the comment file.

Sincerely,

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