
Chapter 1

Introduction

“Sunlight is said to be the best of disinfectants.”

—*Louis Brandeis*

U.S. capital markets are considered the deepest and the most liquid in the world. U.S. total market capitalization—the total value of all shares listed on U.S. stock exchanges—exceeded \$30 trillion in 2018 and accounted for over 40% of worldwide market capitalization. The U.S. corporate bond market is the largest in the world. From 2012 through 2018, initial public offerings in the United States by over 1,200 companies created over \$330 billion in publicly traded equity. U.S. companies rely on the capital markets for a greater portion of their total funding, and on the debt capital markets for a greater portion of their credit financing, than do companies in Europe or Asia. In short, U.S. capital markets play a critical role in both the U.S. and global economy.

The **Securities Act of 1933** was enacted “to provide full and fair disclosure of . . . securities . . . and to prevent frauds in the sale thereof.”

The **Securities Exchange Act of 1934** created the Securities and Exchange Commission and, among other things, imposes ongoing disclosure obligations on companies subject to its requirements.

Transparency is viewed as fundamental to the efficient functioning of these markets. Transparency, in the form of robust disclosures by public companies, helps to protect investors, ensure a level playing field, and promote better allocation of capital. Thus, starting with the Securities Act of 1933 (the 33 Act) and the Securities Exchange Act of 1934 (the 34 Act), laws enacted as part of the New Deal to protect investors from the abuses that led to the 1929 stock market crash, a legal framework has developed that emphasizes mandatory disclosure as a primary regulatory tool. The information that is required to be disclosed enables investors to assess a company's performance and prospects and to decide whether to buy, sell, or hold its securities. Further, both the 33 Act and the 34 Act contain antifraud provisions. Thus, all disclosures—whether voluntary or not—must be truthful, accurate, and complete.

Since inception, the federal statutory scheme focused on disclosure rather than substantive regulation of securities. As articulated by President Franklin Delano Roosevelt at the time the 33 Act was adopted:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. [The 33 Act] puts the burden of telling the whole truth on the seller.

The **U.S. Securities and Exchange Commission** is an independent agency in the executive branch of the federal government. It is composed of five Commissioners appointed by the President and confirmed by the Senate. Commissioners hold office for a term of five years; no more than three may be members of the same political party. One Commissioner serves as Chairman.

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At the staff level, the SEC is organized into divisions. The Division of Corporation Finance administers the 33 Act and the disclosure aspects of the 34 Act. The staff of the Division “seeks to ensure that investors are provided with material information in order to make informed investment decisions, both when a company initially offers its securities to the public and on an ongoing basis as it continues to give information to the marketplace.”

The disclosure requirements of the 33 Act and the 34 Act as implemented by the Securities and Exchange Commission (SEC) provide a baseline for mandatory release of information to the public. This disclosure framework has grown in both volume and complexity, largely based on the premise that availability of the specified information would help inform and protect investors.

SEC disclosure requirements are supplemented by rules of the applicable trading market. To list securities on a securities exchange, companies must enter into a listing agreement that obligates the listed company to comply with applicable stock exchange requirements as a condition to continued trading on that market. These requirements are extensive, and address topics ranging from corporate governance matters to financial statement and accounting practices to required notifications to the stock exchange. Among other things, exchange-imposed obligations address disclosure. Both the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq), for instance, expect listed companies to release promptly to the public any news or information that might reasonably be expected to materially affect the market for its securities.

A **“public company”** or **“reporting company”** is one that is subject to the periodic reporting requirements of the federal securities laws. A company becomes subject to these reporting requirements when:

- the company lists its debt or equity securities on a national securities exchange, such as the New York Stock Exchange or Nasdaq; or
- its assets and shareholders of record exceed certain thresholds; or
- it makes a public offering of securities in the United States without listing on an exchange.

Taken together, the proliferation of SEC legal disclosure mandates coupled with stock exchange listing requirements has increased the burdens and costs imposed on public companies. Not only do public companies incur significant expenditures in complying with SEC and exchange requirements, but they also must maintain the necessary associated infrastructure. Operational areas that may be impacted by the multitude of disclosure requirements:

- Financial reporting, accounting, and internal controls
- Budgeting and forecasting
- Risk management and compliance
- Investor relations and communications
- Disclosure controls
- Corporate governance and board operations
- Executive compensation practices and procedures
- Stock ownership and transactions involving executive officers and directors

In addition to the significantly higher out-of-pocket costs incurred by public companies, robust disclosure requirements have led to greater scrutiny of a public entity's business, operations and prospects, and increased liability for public company executive officers and directors.

The disadvantages associated with public company status have led to repeated calls for, and efforts at, regulatory simplification. Those supporting streamlined disclosure requirements also note the risk of "information overload," where investors are overwhelmed, distracted, or unable to analyze properly a large volume of information. In Justice Thurgood Marshall's words: a company'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."

Given the extensive disclosure requirements now applicable to public companies and the ever-increasing length of public company disclosures, some would argue that we are well past the point of information overload. On the other hand, others would note that

enhanced disclosure on a broad array of topics improves corporate accountability.

Epic disclosures?

“Gobbledygook must go!”

—Former SEC Chairman Arthur Levitt

Public company disclosures continue to grow longer:

- The average prospectus grew from just under 43,000 words in 2000 to over 115,000 words in 2015.
- The average annual report on Form 10-K increased from approximately 30,000 words in 2000 to over 42,000 words in 2013.
- GE’s 2014 Form 10-K contained 103,484 words on 257 pages, including 42,000 words in footnotes.

Concern about overly comprehensive and ineffective disclosures is not new. SEC Chairman John S.R. Shad referred in 1981 to “verbose [SEC disclosures] larded with disclaimers, boilerplates and legalese that obfuscate rather than inform.” Along the same lines, in 1997, in promoting his plain English efforts, SEC Chairman Arthur Levitt stated, “What is the point of disclosure if the people who need it most don’t understand it?” In that same time frame, a spokesperson for the Investment Company Institute observed, “Prospectuses have become so thick and language so technical that it’s difficult for the average American to go through them and pick out key points they need to know.”