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SEC's Disclosure Proposals Compete With Investor Demands

By **Rachel Graf**

Law360 (August 13, 2019, 8:02 PM EDT) -- The U.S. Securities and Exchange Commission's recent proposal to streamline the risk factors companies must disclose could put the companies on a collision course with shareholders who have come to expect a greater volume of information.

The securities regulator's proposed rule would allow companies to disclose risks that are "material" rather than "most significant" as part of an ongoing effort to simplify disclosure requirements. Whether the companies will take advantage of the proposed new standards is unclear, however, given the threat of shareholder lawsuits if their risk disclosures become too lax.

Faced with a choice between spending slightly more time and money on disclosures or potentially facing a shareholder lawsuit, companies tend to choose the former, said Kirkland & Ellis LLP partner Josh Korff, who represents companies in initial public offerings and other transactions.

"It's viewed as relatively cheap insurance," he said.

The proposed changes are part of the SEC's broader push to make company documents more readable and easier for investors to navigate. Congress ordered the SEC to streamline disclosures in 2015 through a provision in the Fixing America's Surface Transportation Act. The bill instructed the SEC to review its Regulation S-K, which lays out various reporting requirements for public companies, and pare back where possible.

Among the changes proposed last week are the new standard for risk disclosures, a requirement that companies include a summary if risk factors exceed 15 pages, and an organizational requirement that would place general investment risks at the end of the risk factors section.

SEC Chairman Jay Clayton said the proposals "should result in improved disclosures and the elimination of unnecessary costs and burdens," according to a statement

Small and midsize companies could very well benefit, said Morgan Lewis & Bockius LLP partner-elect Albert Lung.

Smaller companies that aren't necessarily household names are at a lower risk of facing a shareholder lawsuit and could save money by reducing their disclosures, he said.

Their bigger rivals are more closely watched by shareholders and the media, making it more likely they'll face litigation if their business takes a hit without sufficient warning.

“Big companies — the large 'unicorns' and many public companies — they're at a much higher risk of facing investor lawsuits, shareholder activism,” said Lung, who advises companies on complying with SEC regulations. “There's a lot of incentive for them to overdisclose.”

If a significant risk is buried halfway through a 100-page disclosure, investors might miss it and sue anyway, but shareholders typically aren't going to complain about an abundance of disclosures.

“The notion that, for example, the risk disclosures might be too long in the SEC's estimation is not necessarily going to be a factor that investors are going to be upset about,” said Robbins Geller Rudman & Dowd LLP partner Joseph Russello, who represents investors in securities lawsuits.

Another reason companies might overdisclose is the lack of clarity around what is or isn't material to a business under the proposed rule. Information is generally considered material if a “reasonable investor” would consider it important when making an investment decision.

“That, in some instances, is in the eye of the beholder,” said Ken Joseph, managing director of Duff & Phelps LLC's disputes practice. “And that's why I take the position that a principles-based regime creates more of an opportunity for litigation.”

Ultimately, the SEC isn't requiring companies to disclose material risk factors exclusively.

“This is sort of an SEC suggestion compared to what lawyers and companies see as protection against claims,” Korff said. “It's always going to seem more valuable to buy that protection against claims.”

--Additional reporting by Tom Zanki. Editing by Philip Shea and Alanna Weissman.

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