Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks

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Remarks at the 18th Annual Institute on Securities Regulation in Europe
London, England

March 15, 2019

Good morning. Thank you, John [White] for that kind introduction and to the Practicing Law Institute and Allen & Overy for hosting this event. I am pleased to be here with you today.[1]
Today I would like to discuss how the U.S. securities disclosure requirements, which are largely principles-based, apply in areas where the disclosure topics may be complex, associated with uncertain risks and rapidly evolving. Sounds like Brexit might fit that description, and I don't think I could come to London this week without spending some time discussing it. I realize that you all may be worn out on the subject, and the U.S. regulatory perspective on this topic may seem of secondary or tertiary interest to those of you living through these events. However, I would note that over half of the world's largest companies[2] have their primary listing in the U.S. and a larger proportion trade and report in compliance with our requirements. Given that these companies typically have extensive international operations, including in the U.K. and EU, we have a keen interest in the quality of disclosure that is being provided by the many issuers for which Brexit may have a material impact.
As you know, our disclosure requirements are intended to provide investors with the material information they need about companies and their securities offerings to make informed investment and voting decisions. Robust disclosure decreases information asymmetries and is the foundation of reliable price discovery. When investors have confidence that they are receiving full and transparent disclosure, markets operate more efficiently and the cost of capital is reduced. I think the strength the U.S. markets have displayed over time shows that there is much that is right about our disclosure system and the information it generates and on which market participants rely.

Our disclosure regime emphasizes materiality. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision.[3] Principles-based disclosure requirements articulate an objective and look to management to exercise judgment in satisfying that objective by providing appropriate disclosure when necessary. Management's Discussion and Analysis (MD&A)[4] and Risk Factors[5] are examples of such disclosure requirements and are well-suited to elicit disclosure about complex and evolving areas. Ideally, MD&A allows investors to see a company's results and prospects through the eyes of management. A well written MD&A allows investors to understand how management is positioning the company in the face of uncertainties, like those associated with rapidly evolving topics such as Brexit. Risk factor disclosure should address the most significant things that make an investment in a company and its securities subject to uncertainties or risk. Concise and focused disclosure explaining how each risk affects the company is most useful for investors. Companies should take care not to bury the reader in generic boilerplate or laundry lists of risks that might apply to any company. In addition, companies need to keep in mind that

Commission rules also require them to disclose any further material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.[6] The flexibility of our principles-based disclosure requirements should result in disclosure that keeps pace with emerging issues, like Brexit or sustainability matters, without the need to for the Commission to continuously add to or update the underlying disclosure rules as new issues arise.

Brexit Disclosure

For several months, Chairman Clayton[7] and I have highlighted the need for more robust public company disclosure about how companies are considering Brexit and its possible impact on their business and operations. Today, I would like to focus on the Brexit-related disclosures that we've seen to date, explain how our principles-based disclosure requirements can be applied to Brexit and share with you the types of issues the Division of Corporation Finance may consider when evaluating Brexit-related disclosure in periodic reports in the coming months.

We frequently conduct cross-industry surveys to evaluate the quality of disclosures on complex and evolving topics to inform our filing review process, and I thought Brexit disclosure was an appropriate topic for us to examine. So what did we find? We saw a wide range of disclosures, even within the same industry. Some companies provided generic disclosure, merely stating that Brexit presents a risk, that the outcome is uncertain and that it could materially and adversely impact the business and its operations. In my opinion, this type of disclosure does little to explain to investors the potential specific impact of Brexit on a company's business and operations and is insufficient to guide investors in a meaningful manner.

On a positive note, we've also seen some thoughtful and appropriately detailed disclosures of how Brexit may impact companies. Not surprisingly, we have seen foreign private issuers[8] – companies likely impacted most directly – provide tailored disclosure at a higher rate than U.S. domestic registrants. This suggests that many of you in the audience have done a commendable job advising your clients. And of course, it may reflect the higher expected impacts of Brexit among the community of non-U.S. issuers. That said, we anticipate that there will be international effects that non-U.K. and non-EU issuers will not escape. As Brexit becomes more imminent, and perhaps in response to our public requests for more robust disclosure, we are encouraged to observe that a higher percentage of companies appear to be including tailored Brexit disclosures in their 2018 annual reports. While this is encouraging, we believe there is room for continued improvement.

As you all know too well, there is tremendous uncertainty associated with Brexit, including whether it will be delayed beyond March 29, 2019 to permit further negotiations, or whether it will be reversed or sharply modified through a second referendum or other arrangements. In addition, there is a lack of clarity on what the actual effects of Brexit will be on companies, their investors and on global financial markets. Despite this uncertainty, the reality for many companies is that Brexit is already here. I would think that management and boards have not thrown up their hands in light of the uncertainties and declared that "nothing can be done" – they have been preparing for the variety of outcomes well in advance of March 29. Businesses have not been able to take a wait-and-see approach. Rather, they've had to prepare for a range of outcomes. Your clients likely have made a number of important decisions to mitigate the risk of whatever outcome they may face and investors should know not only the nature and extent of those risks, but also what companies have done to prepare.

As we review disclosures in this area, we appreciate that each company has its own considerations. For example, the Brexit-related disclosure for a large international bank will be different than a multi-national automobile manufacturer, and largely unlike that of a pharmaceutical or life sciences company. Given the differences across industries and companies, there is no one specific data point or prescriptive piece of information that all companies could provide to disclose material information relating to their Brexit-related risks.

Rather, investors are better served by understanding the lens through which each company's management looks at its exposure. How does management assess and analyze Brexit-related risks and the potential impacts on the company and its operations? What is management doing to mitigate and manage these risks? What is the nature of the board's role in overseeing the management of these risks? Depending on the facts and circumstances of each company, the answers to these questions should provide material information to investors seeking to understand the risks attendant to Brexit for that company. One analytical tool to evaluate disclosure in this context is to consider how management discusses Brexit-related risks with its board of directors. Obviously not all discussions between management and the board are appropriate for disclosure in public filings, but there should not be material gaps between how the board is briefed and how shareholders are informed. For those of you involved in crafting

disclosure documents, you can ask yourself a straightforward question: would these disclosures satisfy the curiosity of a thoughtful, deliberative board member considering the potential impact of Brexit on the company's business, operations and strategic plans?

I would like to share some observations of disclosure topics that companies may consider in this context. These are the types of questions that I expect we will have in mind when evaluating Brexit-related disclosures in 2018 annual reports. This list is by no means exhaustive, and the materiality and usefulness of Brexit-related disclosure will always depend on the particular facts and circumstances of the company.

1. Is the business exposed to new regulatory risk given the uncertainty of which set of laws and regulations will apply and whether transition agreements will be in place? We have seen useful, tailored disclosure by some financial institutions that addresses the regulatory risks associated with the potential loss of passporting arrangements that currently permit U.K. entities to provide services to businesses and customers throughout the EU. Similarly, some firms have provided disclosure explaining specific efforts undertaken to re-locate their U.K. operations, or to merge with or acquire EU subsidiaries, to mitigate the regulatory risks of Brexit. Banking and financial services are obviously not the only industries subject to regulatory risk in light of Brexit. Biopharmaceutical companies with substantial U.K. operations face risks concerning how their products and clinical trials will be regulated. Airlines face risks that potential restrictions on flying rights or changes in administration of antitrust laws may negatively impact their joint ventures. For companies in these industries and others affected by regulatory risk, we would expect tailored disclosure explaining these risks where appropriate.
2. Are there significant supply chain risks due to the potential disruption to the U.K.'s access to free trade agreements with other nations and any resulting changes in tariffs on exports and imports? Will potential changes to customs administrations and delays materially impact a company's business, particularly if the business relies on just-in-time supply chains? We believe that companies are actively considering the potential impact of these matters on their business, and we look forward to seeing disclosures that provide insight as to how management is assessing and mitigating these risks.
3. Does the company face a material risk of losing customers, a decrease in sales or revenues or an increase in costs due to tariffs or other factors? Is demand for the company's products especially sensitive to exchange rates or changes in tariffs? Discussion and analysis of these types of questions regarding known trends, demands, commitments, events and uncertainties are critical for investors to understand the extent to which a company's reported financial information is indicative of future results. To the extent management sees the potential impact of Brexit in terms of anticipated costs, reductions in forecasted sales or changes in working capital, it may be appropriate in some cases to include estimates or ranges of quantitative changes, as well as qualitative disclosures.
4. Does the company have exposure to currency devaluation, foreign currency exchange rate risk or other market risk? Given the potential for heightened foreign exchange volatility, we are aware of reports that companies are increasing their hedging activities. We will look at quantitative and qualitative disclosures about market risk to better understand each company's approach to market risk management in this area.
5. What is the company's exposure to contractual risk in the face of Brexit? Has the company undertaken a review of its existing contracts with counterparties in the U.K. or the EU to determine whether renegotiation or termination is necessary in light of contractual obligations? To the extent these discussions involve material contracts, we would expect disclosure to reflect these discussions.
6. Do Brexit-related issues affect financial statement recognition, measurement or disclosure items, such as inventory write-downs, long-lived asset impairments, collectability of receivables, assumptions underlying fair value measurements, foreign currency matters, hedge accounting or income taxes? We expect that boards and audit committees are considering these reporting implications and that these considerations will be discussed in company disclosures, as appropriate.

These are just examples, and how these risks will affect a company's business and how management seeks to mitigate the risks will vary greatly across companies. We have even seen some companies disclose the absence of any actual or anticipated material impact of Brexit on their business. We therefore expect to see a wide range of disclosures about Brexit. However, to the extent material, each company's Brexit disclosure should provide tailored insight into how management views the risks posed to the business and operations and what actions they are taking to address these risks.

Sustainability Disclosure

Another set of issues that illustrates the utility and importance of flexible, principles-based disclosure requirements is the array of issues under the umbrella of environmental, social, and governance, or sustainability, issues. Sustainability disclosure continues to be of interest to investors and other market participants, and the very breadth of these issues illustrates the importance of a flexible disclosure regime designed to elicit material, decision-useful information on a company-specific basis. We understand that investors continue to engage with companies on sustainability topics and that market participants across the globe are giving significant thought to the types of sustainability disclosures the market is seeking as it strives to efficiently allocate capital.

We recognize that market participants have raised questions about the sufficiency of sustainability disclosures, and I think this is a complicated issue. While many market participants have expressed a desire for more specific sustainability disclosure requirements, others have concerns that specific sustainability disclosure requirements could result in disclosure that might not be considered material to a reasonable investor. In addition, market participants who do support additional sustainability disclosure requirements do not themselves uniformly recommend additional disclosure on the same sustainability issues. We hear differing views on whether disclosure requirements should be principles-based or prescriptive, and whether they should utilize a specific set of reporting standards to enhance comparability.

So it appears to me that the market is still evaluating what, if any, additional disclosure on these topics would provide consistently material and useful information. The marketplace evolution of sustainability disclosures is ongoing – companies certainly provide more sustainability information than they did ten years ago – and allowing this evolution to continue should provide market participants with a continued opportunity to sort out the types of information they find useful. Had we leapt into action and issued prescriptive sustainability disclosure requirements when people first began calling for them, I believe we would have stymied that evolution and stifled efforts to develop useful disclosure frameworks. Substituting regulatory prescriptions for market-driven solutions, especially while those solutions are evolving, in my view, is something we need to manage with utmost care. In the meantime, we are watching carefully as market-led approaches develop in this area, and we actively compare the information companies voluntarily provide – typically outside of their SEC filings – with the disclosure we see filed with us.

As we approach this or other disclosure topics, I am always cognizant that imposing specific bright-line requirements can increase the costs associated with being a public company and yet not deliver the relevant and material information that market participants are seeking. Adding requirements to the disclosure regime that do not deliver benefits that justify their costs decreases the attractiveness of our public markets, which in turn can reduce the number of public investment options available to all investors.

As I've mentioned, an important objective of our disclosure framework is to allow investors to see the company through the eyes of management. I encourage companies to consider their disclosure on all emerging issues, including risks that may affect their long-term sustainability. And as they do so I would suggest they ask themselves whether their disclosure is sufficiently detailed to provide insight as to how management plans to mitigate material risks and how their decisions in the area of risk could be material to the business and their investors. Again, this is a process where I believe it is helpful to think about how management engages with board members on the topic.

Let me spend a couple of minutes discussing climate-related disclosures more specifically. Extreme weather events and the continued interest of investors and other market participants in climate-related disclosures have led to a lot of discussion about what companies should disclose about climate or weather-related matters. The Commission published an interpretive release in 2010 that discussed how our existing disclosure requirements may apply to climate-related issues and reminded companies of the need to regularly assess their disclosure obligations as they pertain to climate-related issues.[9] That guidance remains a relevant and useful tool for companies when evaluating their disclosure obligations concerning climate change matters. For example, the guidance discusses how companies with businesses that may be vulnerable to severe weather or climate-related events should consider disclosing material risks of, or consequences from, these events. This remains true today. As another example, it notes that if a company determines that its physical plants and facilities are exposed to extreme weather risks and it is making significant business decisions about relocation or insurance, then, when these matters are material, companies should provide disclosure.

One item the 2010 guidance does not touch upon is the board's risk management role in this area. Item 407(h) of Regulation S-K[10] and Item 7 of Schedule 14A[11] require a company to disclose the extent of its board's role in the risk oversight of the company, such as how the board administers its oversight function and the effect this has on

the board's leadership structure. The Commission has previously highlighted that this should provide investors with important information about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company.[12] To the extent a matter presents a material risk to a company's business, the company's disclosure should discuss the nature of the board's role in overseeing the management of that risk. The Commission last noted this in the context of cybersecurity, when it stated that disclosure about a company's risk management program and how the board engages with the company on cybersecurity risk management allows investors to better assess how the board is discharging its risk oversight function.[13] Parallels may be drawn to other areas where companies face emerging or uncertain risks, so companies may find this guidance useful when preparing disclosures about the ways in which the board manages risks, such as those related to sustainability or other matters.

Conclusion

I appreciate the opportunity to share my thoughts on how our principles-based requirements can be applied to complex, evolving disclosure topics and I hope you enjoy the remainder of the conference.

[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners or other members of the staff.
[2] PricewaterhouseCoopers, Global Top 100 Companies by Market Capitalisation (March 2018), *available at* https://www.pwc.com/gx/en/audit-services/assets/pdf/global-top-100-companies-2018-report.pdf.
[3] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).
[4] Item 303 of Regulation S-K [17 CFR 229.303].
[5] Item 503(c) of Regulation S-K [17 CFR 229.503(c)].
[6] Rule 408 of the Securities Act [17 CFR 230.408]; Rule 12b-20 of the Exchange Act [17 CFR 240.12b-20].
[7] Chairman Jay Clayton, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks (Dec. 6, 2018), *available at*https://www.sec.gov/news/speech/speech-clayton-120618.
[8] Rule 405 of the Securities Act [17 CFR 230.405]; Rule 3b-4 of the Exchange Act [17 CFR 240.3b-4].
[9] Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 8, 2010) [75 FR 6290].
[10] Item 407(h) of Regulation S-K [17 CFR 229.407(h)].
[11] Item 7 of Schedule 14A [17 CFR 240.14a-101].
[12] *See* Proxy Disclosure Enhancements, Release No. 33-9089 (Dec. 16, 2009) [74 FR 68334] ("[D]isclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company.").
[13] Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release No. 33-10459 (Feb. 21, 2018) [83 FR 8166].