

Legal Update

SEC Proposes to Modernize Business, Legal Proceedings and Risk Factor Disclosures

On August 8, 2019, the US Securities and Exchange Commission (SEC) proposed amendments to Regulation S-K that are intended to modernize business, legal proceedings and risk factor disclosures.¹ According to the SEC, the proposed amendments are designed to update rules to account for developments since they were first adopted or last amended and to improve the readability of disclosures for investors while discouraging repetition and disclosure of immaterial information and simplifying compliance for reporting companies. Comments on these SEC proposals are due 60 days after the proposing release is published in the *Federal Register*.

The amendments represent the next step in a series that the SEC has taken to update and modernize the disclosure requirements in Regulation S-K. For example, in August 2018, the SEC adopted disclosure update and simplification amendments, primarily relating to management's discussion and analysis of financial conditions and results of operations and financial statement disclosures, that became effective in November 2018.² And, in March 2019, the SEC adopted modernization and simplification amendments, primarily focusing on other provisions of Regulation S-K,

that became effective in May 2019.³ While the current proposals are coming after these recent amendments to Regulation S-K, the impetus for these proposals predated those amendments. In 2016, as part of the SEC's disclosure effectiveness initiative, the SEC issued a concept release examining many aspects of the business and financial disclosures required by Regulation S-K that companies provide in their periodic reports.⁴

Business Disclosure

In the area of business disclosure, the proposed amendments reflect a movement from prescriptive, line-item disclosure requirements to principles-based disclosure requirements that rely on a company's management to evaluate the significance of information in the context of the company's overall business and financial circumstances in order to determine whether disclosure is necessary. This would permit companies to move from a one-size-fits-all disclosure regime to one that allows disclosures to be tailored to better fit their industry and their specific facts and circumstances. To accomplish this goal, the SEC has proposed amending Item 101(a) of Regulation S-K (*General development of*

business) and Item 101(c) of Regulation S-K (*Description of business*).

General development of business. The proposed amendments to Item 101(a) would require disclosure of developments only to the extent the information is “material to an understanding of the general development of the business.” As proposed, the rule would provide a non-exclusive list of four topics that should be considered for inclusion in this discussion. Although four topics are mentioned in the proposed amendments, the SEC expressly stated in the proposing release that “[t]o the extent that other matters beyond those listed in the amended item are material to an understanding of the general development of a registrant’s business, the registrant would be required to disclose those matters as well.”

Three of the enumerated topics for development of the business disclosure have been retained from current Item 101(a) (bankruptcy; material reclassifications, mergers or consolidations; and material acquisitions and dispositions). In addition, the proposed amendments to Item 101(a) identify as potentially material to the general development of the business “[t]ransactions and events that affect or may affect the company’s operations, including material changes to a previously disclosed business strategy.” Although material changes to a *disclosed* strategy would be reportable, the SEC did not propose making strategy disclosure mandatory so as not to require disclosure of proprietary information that could harm companies’ competitive positions. However, the SEC has asked for comment on whether it should make disclosure of business strategy mandatory.

The SEC has proposed eliminating the prescribed five-year timeframe for business development disclosure, requiring companies to focus on information that is material to understanding the development of their

business without regard to a specific timeframe. In addition, the SEC has proposed that a full discussion of the general development of a company’s business would only be required in the company’s initial filing. Thereafter, only an update of material changes in the reporting period would be required, with an active hyperlink to the company’s most recent filing that, together with the update, would contain the full discussion of the general development of the company’s business.

Description of business. The SEC has also proposed principles-based revisions to Item 101(c). Item 101(c) as proposed to be amended would contain a non-exclusive list of disclosure topics to be discussed in the context of the description of a company’s business. The SEC specified that these proposed topics would not be line-item requirements. However, to the extent material to an understanding of a company’s business, disclosure relating to the identified topics would be required.

Some but not all of the specific disclosure items currently contained in Item 101(c) are referenced in the proposed amendments. Consistent with a change to a principles-based requirement, items currently mentioned in Item 101(c) but not in the proposed amendments would still need to be considered for disclosure if they are material. The proposed amendments to Item 101(c) also enumerate a new topic for consideration for disclosure: human capital resources. This description would include any human capital measures or objectives that management focuses on in managing the business, such as measures or objectives that address the attraction, development and retention of personnel.

Item 101(c) as proposed to be amended, like the current rule, distinguishes between disclosure topics for which segment disclosure should be the primary focus and those that should focus on the company’s business as a whole. For most categories of disclosure that meet the standard of being material to an

understanding of the company's business taken as a whole, the disclosure should be presented by segment. The primary focus of compliance with governmental regulations and human capital resources would be with respect to the business taken as a whole. However, if those topics are material to a particular segment, the company would additionally be required to identify that segment. As proposed, the regulatory compliance category would be refocused to encompass compliance with all material governmental regulations. This would expressly include environmental regulations and would retain the requirement to disclose material capital expenditures for environmental control facilities for the current year. Estimated environmental control expenditures for any other subsequent period would only need to be disclosed as the company deems material.

Legal Proceedings

The SEC has proposed to amend Item 103 of Regulation S-K (*Legal proceedings*) to expressly state that required information "may be provided by hyperlink or cross-reference to legal proceedings disclosure elsewhere in the document, such as in Management's Discussion & Analysis (MD&A), Risk Factors and notes to the financial statements." The proposed amendments to Item 103 also raise the threshold for disclosure of environmental proceedings to which a governmental authority is a party to \$300,000 from \$100,000.

Risk Factors

The SEC has proposed changes to Item 105 of Regulation S-K (*Risk factors*) to address its concerns about the lengthy and generic nature of current risk factor disclosure. First, the proposed amendments would require a risk factor summary if the risk factor discussion exceeds 15 pages. This summary would have to contain a series of short, concise bulleted or numbered statements summarizing the

principal factors that make an investment in the company or offering speculative or risky and would have to appear in the forefront of the prospectus or annual report, as applicable. In the proposing release, the SEC suggested that the 15-page threshold may provide an incentive for companies to limit the length of their risk factor disclosure.

To focus disclosure on the risks to which reasonable investors would attach importance in making investment decisions, the SEC has proposed changing the risk factor disclosure standard contained in Item 105 from the "most significant" risks to "material" risks. The SEC believes that "this approach could result in risk factor disclosure that is more tailored to the particular facts and circumstances of each registrant, which would reduce the amount of risk factor disclosure that is not material and potentially shorten the length of the risk factor discussion, to the benefit of both investors and registrants."

The proposed amendments would also require companies to organize their risk factor disclosure under relevant headings. If a company chooses to disclose a risk that could apply to other companies or securities offerings without explaining why the identified risk is specifically relevant to investors in the company's securities, the proposed rule change would require that generic disclosure to be placed at the end of the risk factor section under the caption "General Risk Factors."

Foreign Private Issuers

The amendments to Items 101 and 103 as currently proposed would affect only foreign private issuers that have elected to file on domestic forms. On the other hand, the proposed amendments to Item 105 would affect foreign registrants because Forms F-1, F-3 and F-4 refer to that item.

The SEC has solicited comment on a number of topics impacting foreign private issuers. For

example, the SEC has asked if it should amend Form 20-F to require disclosure of human capital resources and whether such disclosure would present a significant challenge to foreign private issuers. The SEC has also asked whether Form 20-F should be amended to make business disclosure, which is now largely prescriptive, more principles-based (similar to what the SEC is proposing for domestic issuers). In addition, the SEC has solicited comment on whether Form 20-F should be amended to clarify that a foreign private issuer is only required to disclose material legal proceedings.

Smaller Reporting Companies

The SEC has proposed amending Item 101(h) of Regulation S-K (*Smaller reporting companies*) to eliminate the provision that currently requires smaller reporting companies to describe the development of their business during the last three years. This amendment would also specify that, except for filings other than initial registration statements, a smaller reporting company may provide an update to the general development of the business disclosure in compliance with Item 101(a)(2) instead of a full discussion. Proposed Item 101(h) retains the requirement that if the smaller reporting company has not been in business for three years, it must give the same information for predecessor(s) of the smaller reporting company if there are any.

Practical Considerations

As of the date of this Legal Update, the proposal has not yet been published in the *Federal Register*, so it is not yet known when the comment period will close. And it is too early to predict if and when the SEC will adopt final amendments to Regulation S-K to implement these proposals or when any of those amendments would become effective. The proposed amendments may not be

finalized in time for the upcoming 2020 annual report and proxy season. Nevertheless, it is important for companies to be aware of the proposed amendments and to consider how they would address the amendments if adopted in time to impact their next annual report. Companies should also assess whether they will need to revise any of their disclosure controls and procedures once the SEC finalizes the proposed amendments.

Although the proposed rules may not be adopted in time to impact required disclosure for annual reports for companies with a fiscal year ended December 31, 2019, there are some steps that companies could consider now on a voluntary basis, especially with respect to risk factors. To the extent they are not already doing so, companies could organize their risk factors into subsections, creating headings for various categories of disclosure. If a company discloses risks that apply generally to other companies without identifying how those risks specifically impact it, the company could consider moving those general risks to the end of the risk factors section or removing them. Companies could also review their risk factors to assess whether they could be explained more succinctly. As always, it would be a worthwhile exercise to evaluate the risk factor section from the point of view of readability.

The SEC is soliciting comments in 47 specific areas, many of which contain multiple questions, in addition to a general request for comments. Public companies have the opportunity to influence any final rules by submitting comments. Therefore, they should consider reviewing the proposed amendments and determining whether they want to submit comments or suggest revisions on any of the proposals.

Human capital disclosure as proposed is a new category of business disclosure, going beyond the current requirement to disclose the number of company employees. Human capital has been the subject of a rulemaking petition to

the SEC and is a topic that has been garnering public attention. The SEC has devoted about a page and a half of the proposing release to solicitation of comments with respect to various questions regarding human capital disclosure. Companies should reflect on the questions the SEC has raised in this area. To the extent that they have particular views on human capital disclosure, companies should determine whether they want to submit a comment letter to the SEC to be part of the conversation of whether, and how, this new category should be reflected in the disclosure requirements.

Foreign private issuers should recognize that the proposed risk factor amendments would apply to them and that the SEC is soliciting comments on whether other proposed revisions should also be applicable to foreign private issuers. Therefore, it is important for foreign private issuers to be aware of the proposed amendments. Foreign private issuers may want to consider submitting comments on the questions raised by the SEC that would impact their disclosure and monitor comments received by the SEC in this area. Similarly, smaller reporting companies may want to review the portions of the proposal that impact them and assess whether they want to submit or monitor comments in this area.

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Endnotes

- ¹ Available at <https://www.sec.gov/rules/proposed/2019/33-10668.pdf>.
- ² For further information, see our Legal Update “Capital Markets Implications of Amendments to Simplify and Update SEC Disclosure Rules,” dated August 29, 2018, available at <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2018/08/capital-markets-implications-of-amendments-to-simp/files/updatecapitalmarketsimplicationsofamentmentstosimp.pdf> and our Legal Update “Form 10-Q Guidance on SEC’s Disclosure Update and Simplification Amendments,” dated September 27, 2018, available at <https://www.mayerbrown.com/en/perspectives-events/publications/2018/09/form-10q-guidance-on-secs-disclosure-update-and-si>.
- ³ For further information, our Legal Update “SEC Adopts Rules to Modernize and Simplify Disclosure,” dated March 27, 2019, available at <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/03/skmodernizationadopted.pdf> and our Legal Update “Follow-Up on Regulation S-K Modernization and Simplification,” dated April 3, 2019, available at <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/04/legal-update-follow-up-on-sk-modernization-and-simplification.pdf>.
- ⁴ Available at <https://www.sec.gov/rules/concept/2016/33-10064.pdf>. For further information, see our Legal Update “Modernization of US Business and Financial Disclosures: A ‘Taste’ of the SEC’s Concept Release,” dated April 26, 2016,

available at <https://www.mayerbrown.com/en/perspectives-events/publications/2016/04/modernization-of-us-business-and-financial-disclos>.

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