

Legal Update

SEC Proposes Significant Changes to MD&A and Related Disclosures

On January 30, 2020, the US Securities and Exchange Commission (SEC) continued its recent efforts to modernize and simplify its disclosure requirements by proposing to revise Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)) and to delete several other requirements of Regulation S-K.¹ The SEC is proposing these changes primarily because the disclosures overlap with information that is otherwise provided in the notes to the financial statements or is no longer necessary to be provided in its current format. The proposed amendments "are intended to eliminate duplicative disclosures and modernize and enhance MD&A disclosures for the benefit of investors, while simplifying compliance efforts for registrants."

Over the past several years, the SEC has modernized, or proposed to modernize, several of its rules. This proposal further extends that effort to MD&A and certain related disclosure requirements in Regulation S-K. Comments on the proposals are due 60 days after publication of the proposal in the *Federal Register*.

Proposed Changes to MD&A

The SEC is proposing significant changes to MD&A by adding new requirements to Item 303, deleting some requirements, simplifying some of the instructions to Item 303 and revamping other requirements, all in an effort to streamline the requirements, avoid duplication of disclosure and allow a company to better focus on the disclosure of material information based on its facts and circumstances. The more significant proposed changes to Item 303 of Regulation S-K include:

Proposed new paragraph (a) – objective

The SEC is proposing to add a new paragraph (a) to Item 303 to better clarify the objective of MD&A by incorporating much of current Instructions 1, 2 and 3 to the Item to better emphasize the objective of MD&A for both full fiscal years and interim periods. The proposal also would also recaption current Item 303(a) and (b) as Item 303(b) and (c).

Proposed changes to current Item 303(a) – full fiscal years – to be reflected in new Item 303(b)

Capital Resources. The SEC is proposing to revise current paragraph (a)(2) to require companies to disclose material cash requirements, including commitments for capital expenditures, the anticipated source of funds needed to satisfy these cash requirements and the general purpose of the cash requirements. The objective behind this change is to revise the disclosure requirements to account for capital expenditures that are not necessarily capital investments, recognizing that expenditures for human capital or intellectual property have become increasingly important for some companies. The proposal also would add product lines as an example of other subdivisions that may need to be discussed where necessary to understand a company's business.

Results of Operations. The SEC is proposing three changes to current paragraph (a)(3). First, companies would be required to disclose known events that are reasonably likely to cause a material change in the relationship between costs and revenues, such as known or reasonably likely future increases in costs of labor or materials or price increases or inventory adjustments. The change would use a disclosure threshold of "reasonably likely," which is consistent with the SEC's guidance on forward-looking statements. Second, the SEC is proposing to require that companies disclose the reasons underlying material changes in net sales or revenues. The change would codify existing SEC MD&A guidance. Third, the SEC is proposing to eliminate current paragraph (a)(3)(iv) with regard to specific disclosure with respect to the impact of inflation and changing prices. Companies would still be required to discuss these matters if they are part of a known trend or uncertainty that has had, or they reasonably

expect to have, a material impact on net sales or revenue. This will allow companies to focus on material disclosure that is tailored to their business, facts and circumstances.

Off-Balance Sheet Arrangements. The SEC is proposing to eliminate current paragraph (a)(4) and to replace it with an instruction to Item 303 that would require companies to discuss commitments and obligations arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on their financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources, even when the arrangements result in no obligation being reported in the consolidated balance sheet. This change would prompt companies to consider off-balance sheet arrangements within the broader context of their MD&A.

Tabular Disclosure of Contractual Obligations. The SEC is proposing to eliminate this disclosure requirement currently in paragraph (a)(5). However, companies would be required to discuss material cash requirements as part of their capital resources disclosure, which would pick up material contractual commitments.

Material Changes in Line Items. The SEC is proposing to move a portion of current Instruction 4 into new Item 303(b) to clarify that where there are material changes in a line item, including those that offset each other, disclosure of the underlying reasons for these material changes in quantitative and qualitative terms is required. The change would codify existing SEC MD&A guidance.

Critical Accounting Estimates. The SEC is proposing to add a new paragraph (b)(4) to Item 303 to explicitly require disclosure of critical accounting estimates. This change is intended to codify existing SEC MD&A guidance, eliminate disclosure that duplicates

the financial statement discussion of significant policies and promote enhanced analysis of measurement uncertainties.

Proposed change to current Item 303(b) – quarterly periods – to be reflected in new Item 303(c)

The SEC is proposing to allow companies to compare their most recently completed quarter to either the corresponding quarter of the prior year or to the immediately preceding quarter. This change would give companies the flexibility to choose how to best present quarterly disclosure to investors. Under the proposal, if a company changes the comparison from the prior interim period comparison, it would have to explain the reason for the change and present both comparisons in the filing where the change is announced.

Proposed deletions to Item 303

In light of the changes and deletions to current Item 303(a) discussed above, the SEC is proposing to also delete current paragraphs (c), dealing with a safe harbor for the forward-looking statements, and (d), dealing with the requirements relating to smaller reporting companies.

Other Proposed Deletions

In addition to the revisions to Item 303 discussed above, the SEC is also proposing to eliminate Item 301 of Regulation S-K (Selected Financial Data) and Item 302 of Regulation S-K (Supplementary Financial Information). The changes are designed to modernize the disclosure requirements in light of technological developments, simplify disclosure requirements, reduce repetition and better focus disclosure on material information.

Foreign Private Issuers

Consistent with the proposed changes discussed above and for similar reasons, the SEC is also proposing conforming changes to Form 20-F (the annual report filed by foreign private issuers) and Form 40-F (the annual report filed by Canadian issuers pursuant to the Multijurisdictional Disclosure System).

Other Conforming Amendments

Consistent with the changes proposed by the SEC and to eliminate references to rules the SEC is proposing to eliminate, the SEC is also proposing conforming revisions to Item 914 of Regulation S-K (addressing disclosure in roll-up transactions); Items 1112, 1114 and 1115 of Regulation AB (addressing disclosure in asset-backed securities transactions); Forms S-1 and F-1 (addressing disclosure requirements for summary prospectuses), Forms S-4 and F-4 and Schedule 14A (addressing disclosure requirements in business combination transactions; and Form S-20 (addressing disclosure requirements in standardized option offerings).

Proposed Compliance Date

To allow companies adequate time to adjust their disclosures to the new requirements, the SEC is proposing a transition period of 180 days after their effective date, if and when final rules are adopted, after which companies would be required to comply with the new requirements. In addition, the SEC noted in the proposing release that companies would be able to begin complying voluntarily with the new requirements upon their effectiveness.

Practical Considerations

As of the date of this Legal Update, the proposals have 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 implement these proposals or when any of those amendments would become effective. Although these proposals will not be adopted in time for this upcoming Form 10-K season, it is important to understand the potential changes being considered and begin considering how they will be addressed in the future. However, until any final rules are adopted, companies should not eliminate any disclosure or change any disclosure formats in their upcoming filings that are required by current Regulation S-K.

MD&A is an active area of focus for the SEC and its staff. This is their third effort in this area in the last month. On January 30, 2020, the SEC provided guidance regarding the disclosure of key performance indicators and metrics companies use in MD&A. And on January 24, 2020, the staff of the SEC's Division of Corporation Finance issued three compliance and disclosure interpretations providing additional guidance regarding implementation of MD&A rule changes that were effective in May of 2019, allowing companies to omit from an MD&A discussion the earliest of three years in a filing that includes financial statements covering three years to the extent certain requirements are complied with.² Interested companies should continue to monitor this area for continuing developments.

In addition to a general request for comments on these proposed amendments, the SEC is soliciting comments in 87 specific areas, some of which contain multiple questions. Public companies have the opportunity to influence any final rules by submitting comments. Therefore, they should consider reviewing the proposed amendments and determine whether they want to submit comments or suggest revisions on any of the proposals.

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If you have any questions regarding these proposed changes, please contact the author of this Legal Update, Michael L. Hermsen, at +1 312 701 7960, any of the lawyers listed below or any other member of our Corporate & Securities group.

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¹ See Management's Discussion and Analysis, Selected Financial Data and Supplementary Financial Information, Securities Act Release No. 33-10750 (proposed January 30, 2020), available at <https://www.sec.gov/rules/proposed/2020/33-10750.pdf>.

² For more information on these actions, see our Legal Updates "SEC Issues MD&A Guidance," dated February 4, 2020, and "SEC Adopts Rules to Modernize and Simplify Disclosure," dated March 27, 2019.

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