

August 13, 2019

SEC Proposes Amendments to Modernize Disclosures of Business, Legal Proceedings and Risk Factors

On August 8, 2019, as part of its Disclosure Effectiveness effort, the SEC proposed amendments to three discrete Regulation S-K items – business description, legal proceedings and risk factors. The proposed amendments would update the rules to improve disclosures for investors and simplify the compliance efforts of public companies.

The proposed amendments generally adopt a principles-based approach, particularly in the business description, eliminating some of the more detailed line-item requirements. Not all of the proposals involve streamlining, however. Two proposed changes contemplate more human capital resource disclosure and summary risk factor disclosure if the risk factor section exceeds 15 pages. This Alert highlights key aspects of the proposals.

Proposed Rule

Under the proposed amendments, the description of business (Item 101) and risk factor (Item 105) requirements would adopt a more principles-based approach, which the SEC believes would elicit more relevant disclosures. In contrast, legal proceedings disclosure (Item 103) would largely continue its current prescriptive approach.

General Development of Business (Item 101(a))

Item 101(a) currently requires a description of the general development of the business of a company during the shorter of inception or the past five years. The item lists specific topics that must be covered: year and form of organization; the nature and results of any insolvency proceedings; the nature and results of any other material reclassifications, mergers or consolidations; the acquisition or disposition of any material amount of assets; and any material changes in the mode of conducting the business.

Under the proposed amendments, Item 101(a) would be revised to:

- eliminate the prescribed five-year disclosure timeframe and require companies to focus on information material to an understanding of the development of their business;¹
- permit a company, other than in a company's initial filing, to provide only an update of the general development of the business that focuses on material developments in the reporting period and the requirement to incorporate by reference, and include 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 its business; and
- include a non-exclusive list of the types of information that a company **may** need to disclose (three of which Item 101(a) currently addresses), with a new potential disclosure topic for transactions and events that affect or may affect the company's operations, including material changes to a previously disclosed business strategy.

¹ The proposed amendments would also revise Item 101(h), which permits a smaller reporting company ("SRC") to fulfill its disclosure obligations under Item 101, to eliminate the provision that currently requires SRCs to describe the development of their business during the last three years. However, the SEC is proposing to retain the current requirement in Item 101(h) that if an SRC has not been in business for three years, it must provide the same information for its predecessors. In addition, the SEC is not proposing to amend the prescriptive alternative disclosure standards regarding business development, description of business, and other information specified under Item 101(h)(1)-(6).

Narrative Description of Business (Item 101(c))

Item 101(c) currently requires a narrative description of the business done and intended to be done by the company and its subsidiaries, focusing upon the company's dominant segment or each reportable segment about which financial information is presented in the financial statements. To the extent material to an understanding of the company's business taken as a whole, the description of each such segment must include ten specific items listed in Item 101(c). Item 101(c) also specifies two other items that must be discussed with respect to the company's business in general (compliance with environmental laws and number of employees), although where material the company must also identify the segments to which those matters are significant.

Under the proposed amendments, Item 101(c) would be revised to expand its principles-based approach, by including streamlined versions of disclosure topics drawn from a subset of the topics currently contained in Item 101(c):

- revenue-generating activities, products and/or services, and any dependence on revenue-generating activities, key products, product families or customers, including governmental customers;
- status of development efforts for new or enhanced products, trends in market demand and competitive conditions;
- resources material to a company's business, such as (i) raw materials; and (ii) all patents, trademarks, licenses, franchises and concessions held;
- a description of any material portion of the business that may be subject to renegotiation of profits or termination of contracts or subcontracts at the election of the government;
- seasonality of the business;
- regulatory compliance with material government regulations, not just environmental regulations; and
- human capital disclosure.

Based on the view that "human capital may represent an important resource and driver of performance for certain companies," the proposed rule would replace the current requirement to disclose the number of employees with a requirement that the company describe its human capital resources, including, to the extent material, any human capital measures or objectives that management focuses on in managing the business. The proposed rule provides non-exclusive examples by referring to measures or objectives that address the attraction, development and retention of personnel. The intent of the proposed requirement is to elicit human capital resource disclosures that allow investors to better understand and evaluate the company's human capital resources and to see through the eyes of management how these resources are managed.

Under the more principles-based approach to Item 101(c), some of the bright-line requirements would be eliminated (e.g., information on total revenue contributed by any class of products or services that accounted for 10% or more of the company's consolidated revenue), which should simplify compliance. However, while some of the current Item 101(c) disclosure topics would no longer be explicitly listed in the rule (e.g., working capital practices, information about new segments and backlog), it is worth noting that companies would still have to provide disclosure about these topics, under the proposed principles-based approach, if they are material to an understanding of their business.

Legal Proceedings (Item 103)

Item 103 currently requires disclosure of any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the company or any of its subsidiaries is a party or of which any of their property is the subject. Item 103 also requires disclosure of the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto and a description of the factual basis alleged to underlie the proceeding

and the relief sought. Similar information is to be included for such proceedings known to be contemplated by governmental authorities.

Under the proposed amendments, Item 103 would be revised to:

- expressly state that the required information about material legal proceedings may be provided by including hyperlinks or cross-references to legal proceedings disclosure located elsewhere in a company's filing (e.g., MD&A, risk factors or the notes to the financial statements) in an effort to encourage companies to avoid duplicative disclosure; and
- increase the \$100,000 threshold for disclosure of environmental proceedings to which the government is a party to \$300,000 to adjust it for inflation.

Risk Factors (Item 105)

Item 105 currently requires disclosure of the most significant factors that make an investment in the company or offering speculative or risky and specifies that the discussion should be concise and organized logically. Item 105 further directs companies to explain how each risk affects the company or the securities being offered, discourages the disclosure of generic risks and requires each risk factor to be set forth under a sub-caption that adequately describes the risk.

Under the proposed amendments, Item 105 would be revised to:

- require summary risk factor disclosure in the forepart of a prospectus or annual report, as applicable, if the risk factor section exceeds 15 pages;
- replace the requirement to discuss the “most significant” risks with “material” risks; and
- require risk factors to be organized under relevant headings, with any risk factors that may generally apply to an investment in securities disclosed at the end of the risk factor section under the caption, “General Risk Factors.”

The SEC estimates that the 15-page threshold, if adopted, would affect approximately 40% of current reporting companies. In revising the standard for disclosure from the “most significant” risks to “material” risks, the SEC hopes to encourage companies to focus on disclosing the risks to which reasonable investors would attach importance in making investment decisions.

Comment Period

Interested stakeholders are encouraged to share their views with the SEC on the rule proposal, which contains 47 numbered questions. Comments are due within 60 days following the publication of the proposed rule in the Federal Register.

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If you have any questions or would like to learn more about this proposed rule, please contact your usual legal advisor at Ropes & Gray.