February 10, 2020

SEC Proposes Amendments to Modernize MD&A Disclosures and Provides New MD&A Guidance

January appears to have been MD&A month at the SEC. On January 30, the SEC proposed amendments to modernize, simplify, and enhance its Management's Discussion and Analysis ("MD&A") disclosure rules in Regulation S-K.[1] That same day, the SEC provided new guidance on the disclosure of key performance indicators and metrics in MD&A.[2] Finally, a week earlier, the SEC's Division of Corporation Finance issued three new Compliance & Disclosure Interpretations ("C&DIs") addressing the omission, under recent rule changes, of the MD&A discussion for the earliest of three years.[3]

This Alert highlights these MD&A-related developments. Companies should consider the new guidance when preparing MD&A disclosures for upcoming periodic reports.

Modernization of MD&A Disclosure Requirements – Proposed Amendments

The proposed amendments would significantly revise the existing MD&A requirements. By seeking to reduce duplicative disclosure and focus on material information, the proposed amendments, if adopted, should improve disclosures for investors and reduce the compliance burden for companies.

Specifically, the proposed amendments would eliminate:

- Item 301 – Selected Financial Data;
- Item 302 – Supplementary Financial Information; and
- Item 303(a)(5) – MD&A, Tabular disclosure of contractual obligations.

The rationale behind the elimination of Selected Financial Data and Supplementary Financial Information is that this information is already available in a company's filings, and these tables are, therefore, duplicative. Similarly, the SEC is proposing to eliminate the contractual obligations table given its overlap with information already required in the financial statements and the goal of promoting a principles-based approach to MD&A.

The proposed amendments also include revisions to Item 303 that would:

- add a new Item 303(a), *Objective*, that describes the principal objectives of MD&A;
- amend Item 303(a), *Full fiscal years* (proposed Item 303(b)), and Item 303(b), *Interim periods* (proposed Item 303(c)), to modernize, clarify, and streamline the items;
- replace Item 303(a)(4), *Off-balance sheet arrangements*, with a principles-based instruction about the need to discuss off-balance sheet arrangements in the broader context of MD&A;

[1] Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Release Nos. 33-10750; 34-88093 (Jan. 30, 2020) (available here).
[2] Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-10751; 34-88094 (Jan. 30, 2020) (available here).
[3] Regulation S-K Compliance & Disclosure Interpretations: Questions 110.02, 110.03, and 110.04 (Jan. 24, 2020) (available here).

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- add a new Item 303(b)(4), *Critical accounting estimates*, to clarify and codify SEC guidance on critical accounting estimates;
- revise the interim MD&A requirement in Item 303(b) to provide flexibility by allowing companies to compare their most recently completed quarter to either the corresponding quarter of the prior year (as is currently required) or to the immediately preceding quarter;
- eliminate current Item 303(c), *Safe harbor*, in light of the proposed replacement of Item 303(a)(4) and elimination of Item 303(a)(5); and
- eliminate Item 303(d), *Smaller reporting companies*, in light of the proposed elimination of Items 303(a)(3)(iv) and 303(a)(5).
- The proposed amendments also include certain conforming amendments to Forms 20-F and 40-F, as appropriate. The deadline to submit comments to the SEC on the rule proposal is no later than 60 days after the proposal's publication in the *Federal Register*.[4]

Key Performance Indicators and Metrics in MD&A – New SEC Guidance

On January 30, 2020, the SEC provided new guidance on the disclosure of key performance indicators and metrics in MD&A. Examples of metrics to which the guidance will apply include:

- operating margin;
- same store sales;
- sales per square foot;
- total customers/subscribers;
- average revenue per user;
- daily/monthly active users/usage;
- active customers;
- net customer additions;
- total impressions;
- number of memberships;
- traffic growth;
- comparable customer transactions increase;
- voluntary or involuntary employee turnover rate;
- percentage breakdown of workforce (e.g., active workforce covered under collective bargaining agreements);
- total energy consumed; and
- data security measures (e.g., number of data breaches or number of account holders affected by data breaches).

[4] As of the date of this Alert, the proposal had not yet been published in the *Federal Register*.

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The guidance reminds companies that, when including metrics in their disclosure, they should consider existing MD&A requirements and the need to include such additional material information (e.g., whether there are particular estimates or assumptions underlying a metric or its calculation that also should be disclosed) necessary in order to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading. The SEC stated that it generally expects, based on the facts and circumstances, the following disclosures to accompany any metric:

- a clear definition of the metric and how it is calculated;
- a statement indicating the reasons why the metric provides useful information to investors; and
- a statement indicating how management uses the metric in managing or monitoring the performance of the business.

The guidance further advises that, if a company changes the method by which it calculates or presents the metric, the company should consider disclosure of:

- the differences in the way the metric is calculated or presented compared to prior periods;
- the reasons for such change;
- the effects of any such change on the amounts or other information being disclosed and on amounts or other information previously reported; and
- other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects.

Depending on the significance of any changes in methodology and results, the company also should consider whether to recast prior metrics to conform to the current presentation and place the current disclosure in an appropriate context.

Importantly, the guidance notes that when key performance indicators and metrics are material to an investment or voting decision, the company should consider whether it has effective disclosure controls and procedures in place to process information related to such items to ensure consistency as well as accuracy.

The guidance, which is substantially consistent with comments and statements the SEC staff has made about metrics, will become effective on the date of its publication in the *Federal Register*,[5] but companies should review the new guidance as they prepare MD&A disclosures for upcoming periodic reports.

We also note that the SEC's Division of Enforcement has brought a number of cases recently where companies have faced issues with changes to how they reported non-financial statement metrics in earnings calls as well as filed financial statements so it is not surprising to see this guidance incorporated in MD&A reporting regulations. For example, in *SEC v. Aegerion,* the SEC alleged that the company negligently over-reported the conversion rate of new patients who received prescriptions when the CEO stated that the "overwhelming majority" of individuals receiving prescriptions converted to actual customers when in fact the actual number was just over 50%.[6] In the *Endurance/Constant Contact* matters, the SEC brought enforcement actions against the companies for failing to disclose that they had changed how they counted subscriptions to their web hosting and internet-based marketing products such that the numbers reported were inflated.[7] We have extensive experience in assisting companies dealing with inquiries into issues related to such matters and are happy to share our insights into such matters.

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[5] As of the date of this Alert, the guidance had not yet been published in the *Federal Register*.
[6] *SEC v. Aegerion Pharmaceuticals, Inc.*, Litigation Release No. 23942 (Sept. 22, 2017) (available here).
[7] SEC Charges Online Marketing Company for Inflating Subscriber Numbers, SEC Press Release (June 5, 2018) (available here).

Omitting the Discussion of the Earliest of Three Years in MD&A – New C&DIs

Under the SEC's FAST Act-related amendments to Regulation S-K (summarized here), Item 303(a) now permits a company, in a filing providing three years of financial statements, to omit the MD&A discussion of the earliest year if the discussion appears in a prior filing on EDGAR and the company includes a statement identifying where the omitted discussion may be found. On January 24, 2020, the SEC's Division of Corporation Finance issued three new Regulation S-K C&DIs to assist companies as they evaluate whether to take advantage of this new disclosure flexibility in upcoming annual reports on Form 10-K.

The guidance offers two principal takeaways:

- The identifying cross reference **does not** incorporate the earlier discussion by reference unless the company expressly so provides. That is true for references to annual reports (Question 110.02) and registration statements that incorporate those annual reports by reference (Question 110.04).
- A company may not omit an earlier period discussion (or presumably any portion of the discussion) that is necessary to an understanding of its financial condition, changes in financial condition, and results of operations (Question 110.03).

Notably, the SEC's final rule implementing its FAST Act-related amendments to Regulation S-K did not include an explicit condition that the omission not be "material to an understanding" of the company's financial condition, changes in financial condition, and results of operations. The SEC did not adopt this explicit materiality condition as it viewed the condition as superfluous and potentially confusing. In the adopting release, the SEC stated:

> "[W]e are not adopting, as an explicit condition, that the omitted discussion must not be 'material to an understanding' of the registrant's financial condition, changes in financial condition, and results of operations. This is not to suggest, however, that materiality is not relevant to management's judgment about what disclosure is provided in MD&A. Materiality remains, as always, the primary consideration. Rather, this change recognizes that the language of the proposed condition was superfluous and never intended to modify, supplement, or alter the overarching materiality analysis that management must undertake with respect to the information it provides investors in MD&A."[8]

Whether there is a difference between a discussion that is "necessary to an understanding" and one that is "necessary to make what was said not misleading" is anyone's guess. Any question about whether the earliest year has information that is meaningfully different from the two most recent years should be resolved by including it or incorporating it by reference.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

[8] FAST Act Modernization and Simplification of Regulation S-K, Release Nos. 33-10618; 34-85381, 84 Fed. Reg. 12674, 12679 (Apr. 2, 2019) (available here).

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