

August 31, 2020

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

On August 26, 2020, as part of its Disclosure Effectiveness effort, the SEC adopted [amendments](#) to three discrete Regulation S-K items – business description, legal proceedings and risk factors. The amendments are intended to update the rules to reflect our current capital markets and economy, improve disclosure for investors and simplify compliance for public companies. This Alert highlights key aspects of the final rule amendments.

Key Takeaways

Although the thrust of the amendments is principles-based, the amendments add two new specific requirements: (1) human capital resource disclosure and (2) a risk factor summary if the risk factor section exceeds 15 pages. The amendments, which will become effective 30 days after publication in the Federal Register, will impact a wide variety of SEC filings, including upcoming annual and quarterly reports and the initial filings of registration statements. If the amendments are officially published next week, then they will become effective in early October.

Modernization of Regulation S-K Items 101, 103 and 105

The amendments were adopted substantially in the form proposed a year ago. Under the amendments, the description of business (Item 101) and risk factor (Item 105) disclosure requirements become more principles-based, which the SEC believes will elicit more relevant disclosures. In contrast, legal proceedings (Item 103) disclosure requirements largely continue their 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 past five years or, if shorter, since inception. The item lists specific required topics: 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.

The amendments revise Item 101(a) to:

- eliminate the prescribed five-year disclosure timeframe and require a company to focus on information material to an understanding of the development of its business;¹
- permit a company, other than in its initial filing, to provide only an update of the general development of the business that focuses on any material developments since the most recent full discussion of the general development of its business; and
- replace the list of prescribed disclosure topics with a non-exclusive list of types of information that a company **may** need to disclose to the extent such information is material to an understanding of the general development of the company's business.

Under the amendments, if a company chooses to provide only an update since the most recent full discussion of the general development of its business, it must incorporate by reference, and include an active hyperlink to, the company's filing that contains such full discussion. Information must not be incorporated by reference in any case where such

¹ The amendments also revise Item 101(h), applicable to smaller reporting companies ("SRCs"), to eliminate the provision that currently requires SRCs to describe the development of their business during the last three years.

incorporation would render the disclosure incomplete, unclear or confusing, such as incorporating by reference from a second document if that second document incorporates information pertinent to such disclosure by reference to a third document. For example, a filing that includes an update and incorporates by reference the more complete Item 101(a) discussion could not be incorporated by reference into a subsequent Form S-3 or Form S-4 filing. As this approach is more restrictive than existing incorporation by reference rules, we may see fewer companies choose to avail themselves of this new option.

In a slight change from the proposal, the SEC eliminated the requirement to disclose transactions and events that affect or may affect the company's operations, but maintained the requirement to disclose material changes to a company's previously disclosed business strategy. The amendments retain the existing disclosure topics addressing the results of any bankruptcy, receivership or similar proceedings, the nature and results of any other material reclassification, merger or consolidation of the company or any of its significant subsidiaries, and the acquisition or disposition of any material amount of assets.

Narrative Description of Business (Item 101(c))

Item 101(c) currently requires a narrative description of the company's business, focusing upon the company's dominant segment or each reportable financial statement segment. The requirements focus mainly on specific line-items.

Under the amendments, Item 101(c) includes streamlined versions of disclosure topics in a non-exclusive list (drawn in part 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) the duration and effect of 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 **all** material government regulations, not just environmental regulations; and
- human capital disclosure, including the number of the company's employees.

One of the more notable features of the amendments is the requirement to include, to the extent material to an understanding of the company's business taken as a whole, a description of the company's human capital resources, including any human capital measures or objectives on which the company focuses in managing the business. The amendments identify various human capital measures and objectives that address the attraction, development and retention of personnel as non-exclusive examples of subjects that may be material, depending on the nature of the company's business and workforce. The amendments do not require companies to use a specific disclosure standard or framework to provide human capital disclosure but instead affords companies with the flexibility to tailor their disclosures to their unique circumstances. In the adopting release, the SEC explained that it decided neither to adopt a definition of the term "human capital" nor to include more prescriptive human capital disclosure requirements because it recognized that the exact measures and objectives included in human capital management disclosure may evolve over

time and may vary significantly based on a number of factors, such as industry, geography, company strategy and other conditions that affect human capital resources. In his [statement](#) at the Open Meeting, Chairman Clayton noted that, under the principles-based approach, he expects to “see meaningful qualitative and quantitative disclosure, including, as appropriate, disclosure of metrics that companies actually use in managing their affairs.”

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.

The amendments revise Item 103 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) to avoid duplicative disclosure; and
- implement a modified disclosure threshold for certain governmental environmental proceedings resulting in monetary sanctions that increases the threshold for disclosure of such proceedings from the existing \$100,000 to \$300,000, or, if a company reasonably determines that such higher threshold would result in disclosure of material environmental proceedings, to the lesser of \$1 million and 1% of the company’s current assets.

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.

The amendments revise Item 105 to:

- require, if the risk factor section exceeds 15 pages, a bullet point summary of the principal risk factors that is no more than two pages in the forepart of a prospectus or annual report, as applicable;
- refine the principles-based approach of Item 105 by changing the standard for disclosure from the “most significant” risks to “material” risks that make an investment in the company or offering speculative or risky; and
- require risk factors to be organized under relevant headings in addition to the sub-captions currently required, with any risk factors that may generally apply to an investment in any company or offering of securities disclosed at the end of the risk factor section under the caption, “General Risk Factors.”

In a change from the proposal, the amendments limit the risk factor summary to no more than two pages. Since the risk factor summary is not required to contain all of the risk factors identified in the full risk factor discussion, companies may want to prioritize certain risks and omit others in this summary section. The SEC noted that the risk factor summary may create an incentive for companies to reduce the length of their risk factor discussion to avoid triggering the new summary requirement. In addition, the SEC encourages companies to tailor their risk factor disclosures to emphasize the specific relationship of the risk to the company or the offering, and thereby obviate the need to include any risk factors under the general risk caption.

Final Observations

We would not expect the amendments, which companies for the most part should welcome, to have a significant impact on disclosures under these Regulation S-K items. Companies, however, will need to promptly consider how they intend to respond to the human capital disclosure requirement. Larger companies may find it untenable to conclude how they manage human capital is not material to their business. In addition, companies that only barely exceed the 15-page risk factor threshold should consider surgical edits to avoid having to prepare a summary. Companies that are well above the 15-page threshold should begin evaluating which of their risk factors merit inclusion in their risk factor summaries.

We expect the amendment to Item 101(c) to, over time, result in substantially more human capital-related disclosure in applicable filings. As part of their integration of social factors into investment and voting decisions, mainstream institutional investors are clamoring for greater visibility into human capital management, including around diversity and inclusion, wages, employee health and safety, hiring practices, talent management and promotion and alignment of corporate culture with company purpose and stated values. Much of this information will appropriately continue to sit outside of SEC filings – in CSR reports or on corporate websites – given that not all of it is material to investment or voting decisions. However, the amendment to Item 101(c) will require companies to determine what, if any, new disclosure they need to prepare for their SEC filings, and, for companies that already publish human capital-related disclosure in other contexts, how much of this disclosure to include in their filings. Stakeholder constituencies have not been shy about their human capital disclosure expectations. We expect the amendment to result in a rash of new human capital disclosure expectations and guidance documents in the coming weeks and months, followed by the inevitable benchmarking reports and rankings. Human capital disclosure will be a continually evolving area for companies, reflecting broader developments in human capital management and investor expectations.

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