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Legal Update

SEC Amends Business, Legal Proceedings and Risk Factor Disclosures

On August 26, 2020, the US Securities and Exchange Commission (SEC) adopted amendments to Regulation S-K that are intended to modernize business, legal proceedings and risk factor disclosures.[1] According to the SEC, the amendments are designed to update rules, to improve the readability of disclosures and to simplify compliance for reporting companies. These amendments become effective 30 days after the adopting release is published in the *Federal Register*.

Background

The amendments, initially proposed in August 2019,[2] represent one of a series of steps that the SEC has taken to update and modernize the disclosure requirements in Regulation S-K. For example, in 2016, as part of the SEC's disclosure effectiveness initiative, the SEC issued a concept release requesting comment on many aspects of the business and financial disclosures required by Regulation S-K.[3] Thereafter, in August 2018, the SEC adopted disclosure update and simplification amendments, primarily relating to management's discussion and analysis of financial condition and results of operations (MD&A) and financial statement disclosures that became effective in November 2018.[4] In March 2019, the SEC adopted modernization and simplification amendments, primarily focusing on other provisions of Regulation S-K, which became effective in May 2019.[5] The SEC proposed amendments to the MD&A provisions, selected financial data and supplementary financial information in January 2020.[6] And in May 2020, the SEC amended the requirements for financial disclosures for acquired and disposed businesses.[7] In short, the impetus for the current modernization amendments has been years in the making.

Business Disclosure

The amendments to Item 101(a) of Regulation S-K (*General development of business*) and Item 101(c) of Regulation S-K (*Description of business*) reflect a move away 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 approach permits companies to move from a one-size-fits-all disclosure regime to one that allows for tailored disclosures that better fit their industry and their specific facts and circumstances.

General development of business. Previously, Item 101(a) required a description "of the general development of the business of the registrant, its subsidiaries and any predecessor(s) during the past five years" and "for earlier periods if material to an understanding of the general development of the business." The amendments to Item 101(a) require disclosure of the general development of the business only to the extent the information is "material to an understanding of the general development of the business." As amended, the rule provides a non-exclusive list of four topics that should be considered for inclusion in this discussion but makes clear that if there are other matters material to an understanding of the general development of company's business, the company will be required to disclose them.

Three of the enumerated topics are modified versions of existing requirements (material bankruptcies of the company or any of its significant subsidiaries; material reclassifications, mergers or consolidations; and material acquisitions and dispositions). A new topic for consideration for disclosure is any material changes to a previously disclosed business strategy. Although material changes to a *disclosed* strategy are potentially reportable, strategy disclosure itself is not mandatory.

The SEC has eliminated the prescribed five-year timeframe for disclosure, requiring companies to focus on information that is material to understanding the development of their business without regard to a specific timeframe. A company may forgo providing a full discussion of the general development of its business for a filing, other than an initial registration statement, if it provides an update regarding its business, disclosing all of the material developments that have occurred since the most recent registration statement or report that includes a full discussion of the business. In order to do so, however, the company must incorporate by reference and include one active hyperlink to a single, previously filed registration statement or report that includes the full discussion. If the company does not choose this approach, it must provide a complete discussion, including any material updates in each filing that requires such disclosure.

Description of business. Previously, Item101(c) required a description of "the business done and intended to be done by the registrant and its subsidiaries, focusing upon the registrant's dominant segment or each reportable segment about which financial information is presented in the financial statements" and identified specific topics that were required to be disclosed. The SEC has made principles-based revisions to Item 101(c). Item 101(c) was amended to contain a non-exclusive list of disclosure topics, including some from current Item 101(c), to be discussed in the context of the description of a company's business. These topics are not prescriptive line-item requirements but are only required to be addressed to the extent material to an understanding of a company's business.

The amendments to Item 101(c) also enumerate a new topic for consideration for disclosure: a description of human capital resources. If required to be addressed, a human capital resources discussion would need to include, to the extent material to an understanding of a company's business, the number of persons employed by the company and any human capital measures or objectives that the company focuses on in managing the business, such as measures or objectives that address the development, attraction and retention of personnel. According to the adopting release, the SEC believes "that, in many cases, human capital disclosure is important information for investors" and that "[h]uman capital is a material resource for many companies and often is a focus of management, in varying ways, and an important driver of performance."

Item 101(c) as amended 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 meets 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 is with respect to the business taken as a whole. However, if those topics are also material to a particular segment, the company additionally is required to identify that segment.

The regulatory compliance category has been refocused to encompass the material effects of compliance with all governmental regulations on capital expenditures, earnings and the competitive position of the company and its subsidiaries. This disclosure requirement expressly includes environmental regulations. Companies must disclose estimated capital expenditures for environmental control facilities for the current year and any other material subsequent period.

Legal Proceedings

Previously, Item 103 of Regulation S-K (*Legal proceedings*) required a brief description of "any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject," as well as any such proceedings known to be contemplated by governmental authorities. The SEC amended Item 103 to expressly permit providing the required information by hyperlink or cross-reference to legal proceedings disclosure elsewhere in the document, such as in MD&A, risk factors or notes to the financial statements.

The amendments to Item 103 also raise the threshold for disclosure of environmental proceedings to which a governmental authority is a party from $100,000 to $300,000. Alternatively, a company has the flexibility to select a different threshold that

- it determines is reasonably designed to result in disclosure of any such proceeding that is material to the business or financial condition,
- it discloses (including any change thereto) in each annual and quarterly report, and
- does not exceed the lesser of $1 million or 1 percent of the current assets of the company and its subsidiaries on a consolidated basis.

Risk Factors

Previously, Item 105 of Regulation S-K (*Risk factors*) required, where appropriate, "a discussion of the most significant factors that make an investment in the registrant or offering speculative or risky." The SEC has revised Item 105 to address concerns about the lengthy and generic nature of current risk factor disclosure. First, the amendments require a risk factor summary of not more than two pages if the risk factor discussion exceeds 15 pages. This summary must contain a series of concise bulleted or numbered statements summarizing the principal factors that make an investment in the company or offering speculative or risky and has to appear in the forepart of the prospectus or annual report, as applicable. The summary does not have to contain all of the risk factors described in the full risk factor discussion. Companies may prioritize certain risks in, and omit others from, the summary.

To focus disclosure on the risks to which reasonable investors attach importance in making investment decisions, the SEC changed the risk factor disclosure standard contained in Item 105 from the "most significant" risks to "material" risks. The amendments 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 amended rule requires that generic disclosure be placed at the end of the risk factor section under the caption "General Risk Factors."

According to the adopting release, the SEC believes these amendments "will result in risk factor disclosure that is more tailored to the particular facts and circumstances of each registrant, which should reduce the disclosure of generic risk factors and potentially shorten the length of the risk factor discussion, to the benefit of both investors and registrants."

Foreign Private Issuers

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

Smaller Reporting Companies

The SEC amended Item 101(h) of Regulation S-K (*Smaller reporting companies*) to eliminate the provision that currently requires smaller reporting companies (SRCs) to describe the development of their business during the last three years. This amendment specifies that a SRC may forgo providing a full discussion of the general development of its business for a filing other than an initial registration statement but only if it provides an update to the general development of its business by disclosing all of the material developments that have occurred since the most recent registration statement or report that includes a full discussion of the general development of its business. In addition, it must incorporate by reference, and include one active hyperlink to one registration statement or report that includes, the full discussion of the general development of its business.

Practical Considerations

Because the amendments will be effective 30 days after publication in the *Federal Register*, they will impact upcoming filings, such as Form 10-Qs and Form 10-Ks and certain registration statements under the Securities Act of 1933 filed after the effective date. Therefore, companies should immediately begin considering whether and how they will modify their disclosures to implement the amendments. Companies should also assess whether they will need to revise any of their disclosure controls and procedures to reflect the amendments.

If companies have or expect to have more than 15 pages of risk factor disclosure, they will need to develop a two-page summary. Some companies may choose to shorten their risk factor discussions to avoid triggering the summary requirement, but they will need to balance that decision against the risk of litigation that potentially could arise from risk factor disclosure that is alleged to be deficient. Preparing a summary of the principal factors that make investment in a company speculative or risky or deciding to shorten a previous risk factor discussion will require thoughtful and careful drafting. Companies should begin that exercise well before the filing date to allow time for review, especially if revised disclosure is being prepared. Companies with longer risk factor disclosure may want to consider initially preparing both a two-page summary and a full risk factor discussion that is no longer than 15 pages in order to evaluate which approach works best for them.

Companies should also review their risk factors to assess whether they could be explained more succinctly, which could avoid the need to have both summary risk factors and more detailed explanations of risk factors. To the extent they are not already doing so, companies need to organize their risk factors into subsections, creating headings for various categories of disclosure. This could lengthen a risk factor discussion. As always, it would be a worthwhile exercise to evaluate the risk factor

section from the point of view of readability. If a company discloses risks that apply generally to other companies without identifying how those risks specifically impact it, the company will need to move those general risks to the end of the risk factors section under the caption "General Risk Factors" or remove them.

As a result of the amendments, human capital resources need to be disclosed pursuant to Item 101(c) to the extent such disclosures are material to an understanding of the company's business. Since the time this requirement was proposed a year ago, the COVID-19 pandemic heightened interest in human capital matters, with investors seeking engagement on workplace safety, remote working issues, succession planning and the impact of these matters on business continuity. In addition, protests over racial and social injustice have sparked conversations relating to workplace discrimination, as well as to the role played by public companies in social change. Even before the pandemic, human capital has been discussed within the environmental, social and governance (ESG) context, especially as issues such as board and workforce diversity and pay equity garnered greater attention. In light of the heightened sensitivity regarding the importance of human capital, companies may receive pushback if they take the position that they do not need to discuss human capital resources in the business section because they do not consider it material.

As a result of the confluence of COVID-19 and social unrest, layered on issues already part of the ESG dialogue, human capital is poised to take on increasing importance beyond the new business section disclosure requirements. Some large institutional investors have made human capital management a priority for engagement. In addition to required board diversity, pay ratio disclosure and board risk oversight disclosure, some companies have already expanded human capital disclosure in their proxy statements or on their websites. As companies determine how they will frame human capital disclosure in the context of their business discussions, it may be beneficial to consider at the same time whether to provide additional human capital disclosure in their proxy statements and/or on their websites in order to coordinate their messaging on this issue.

Companies should begin thinking about the focus of their human capital disclosures and begin drafting the specific language and designing any related presentation sufficiently well in advance of filing deadlines to allow time for review by various company personnel and outside advisors. Companies should anticipate that their human capital disclosures will attract scrutiny from various stakeholders, as well as from the SEC. Another benefit to early consideration of expanded human capital disclosures is that the exercise also serves as preparation for shareholder engagement on the topic.

Foreign private issuers should recognize that the risk factor amendments apply to them and assess how they will modify their risk factor disclosures to comply with the new requirement. Similarly, SRCs should review the portions of the amendments that impact them and determine how they will update their disclosures.

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Endnotes

[1] Available at https://www.sec.gov/rules/final/2020/33-10825.pdf

[2] Available at https://www.sec.gov/rules/proposed/2019/33-10668.pdf

[3] 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

[4] 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/updatecapitalmarketsimplicationsofamendmentstosimp/fileattachment/updatecapitalmarketsimplicationsofamendmentstosimp.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

[5] For further information, see 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

[6] https://www.sec.gov/rules/proposed/2020/33-10750.pdf

[7] https://www.sec.gov/rules/final/2020/33-10786.pdf

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