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SEC Adopts a More Principles-Based Approach to Public Company Disclosure Requirements

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On August 26, 2020, the Securities and Exchange Commission adopted amendments to Regulation S-K that simplify and modernize the disclosure requirements relating to description of business, legal proceedings, and risk factors, which apply to public company registration statements and periodic reports. While the amended rules will require additional disclosure in some cases, several existing disclosure mandates have been eliminated. Overall, the amendments are intended to provide a more principles-based approach to business description requirements, eliminate duplicative disclosure through the use of cross-references and hyperlinks, and improve readability of risk factor disclosure by requiring topical headings and, in some cases, a risk factor summary. Significantly, the amended rules include a new disclosure topic in the description of business relating to human capital resources.

The changes will be effective 30 days after publication in the Federal Register and accordingly should be effective before the next 10-Q filings by calendar year companies.

Changes to Item 101 – Description of Business

The new rules amend Item 101(a) (General Development of Business), Item 101(c) (Narrative Description of Business) and Item 101(h) (Smaller Reporting Companies). The amendments replace certain prescriptive disclosure requirements with principles-based rules, giving companies greater flexibility to provide disclosures that are appropriately tailored to their business.

Narrative Description of the Business

Prior to the amendments, Item 101(c) listed 13 disclosure items to be discussed by companies in their business description. The amendments to Item 101(c) eliminate the requirement to disclose a prescribed list of items. Instead, the amended rule provides a non-exclusive list of disclosure topics, many of which were contained in Item 101(c) before the amendments. Topics retained from the prior version of the rule include information relating to revenue generating activities, products and services, dependence on key customers, raw materials, duration and effect of patents, trademarks and licenses, and seasonality. The amended rule makes clear that companies must address these topics only to the extent they are material to an understanding of the business.

The amendments to Item 101(c) eliminate explicit references to disclosure of working capital practices, new segments and the dollar amount of backlog orders believed to be firm. The SEC stated in the adopting release, however, that companies must still provide disclosure about these topics, as well as any other topics regarding their business, if they are material to an understanding of the business and are not otherwise disclosed.

Prior to the amendments, Item 101(c) required companies to provide disclosure about the material effects of compliance with environmental laws and regulations. The amended rule expands the scope of this topic and will require, to the extent material to an understanding of the business, disclosure of the material effects that compliance with all government regulations, including environmental regulations, may have upon the capital expenditures, earnings, and competitive position of the company and its subsidiaries. The SEC noted that many companies provide this type of disclosure already, and expanded disclosure will be required only to the extent it is material. The amended rule also will continue to require companies to include the estimated capital expenditures for environmental control facilities for the current fiscal year and any other subsequent period that is material.

Human Capital Disclosure

One new disclosure topic included in Item 101(c), as amended, is a description of the company's human capital resources, including the number of employees and any human capital measures or objectives that the company focuses on in managing the business. The amended rule identifies "measures and objectives that address the attraction, development and retention of personnel" as non-exclusive examples of human capital measures that may be material. Importantly, these disclosures – like other topics identified in the amended rule – are required only to the extent the information is material to an understanding of the company's business as a whole.

While the final rule will require a company to disclose the number of persons employed, to the extent material to an understanding of the company's business, the SEC chose not to expand the rule to include additional metrics, such as the number of part-time employees, full-time employees, independent contractors, contingent workers or employment turnover. Nevertheless, the adopting release clearly states that such measures must be disclosed if they are material to the understanding of a company's business.

The SEC noted that there has been growing interest in human capital disclosure, and a petition for rulemaking regarding human capital management disclosure was submitted in 2017 by a group of institutional investors. In its comment letter on the proposed rules, the Sustainability Accounting Standards Board ("SASB") described "human capital management" as:

> the management of a company's human resources (employees and individual contractors) as key assets to delivering long-term value. It includes issues that affect labor relations as well as the health and safety, and employee engagement/productivity, and diversity and inclusion.

The SEC declined to include a definition of "human capital management" in the amended rule. Moreover, dissenting statements of Commissioners Allison Herren Lee and Caroline Crenshaw criticized the final rule for failing to address diversity and climate change. Companies will need to exercise careful judgment about what constitutes human capital measures or objectives, and they should be prepared to provide qualitative and quantitative disclosure, including metrics, that the company uses to manage its business.

General Development of the Business

Currently, Item 101(a) requires a company to disclose the general development of its business during the past five years. This disclosure must include information about the company's corporate organization, its business, any bankruptcy proceedings, reclassifications, mergers or consolidations, material asset acquisitions or dispositions and material changes in the company's mode of conducting business. The amendments eliminate the five-year look-back. Instead, the new rules will require companies to disclose information material to an understanding of the development of their business, without a prescribed timeframe. Similarly, the amendment to Item 101(h) will eliminate the provision that requires smaller reporting companies to describe the development of their business during the last three years, and will direct smaller reporting companies, to provide information for the period of time that is material to an understanding of the general development of the business.

As amended, Item 101(a) also replaces the prescriptive list of disclosure items with a non-exclusive list of topics that companies may need to address in their disclosure. The list of topics is similar to the current list, but not identical. As amended, information about the company's corporate organization and material changes in the mode of conducting business are no longer included on the topic list. Companies should be aware that the list of disclosure topics is not exclusive; topics that are not included on the list must nevertheless be disclosed if the information is material to an understanding of the general development of the company's business.

In a change from the current topic list, amended Item 101(a) includes a reference to material changes to a company's previously disclosed business strategy. The new disclosure topic does not require companies to disclose business strategy, and the adopting release emphasizes that the principles-based approach provides companies with flexibility to determine the appropriate level of detail for these disclosures. The SEC also declined to adopt a definition of "business strategy" in the new rules, in order to provide companies with more flexibility to tailor their disclosures according to their facts and circumstances. Companies will need to consider whether they have previously disclosed a business strategy and whether any subsequent changes to that strategy are material changes that must be disclosed.

As amended, Item 101(a)(2) permits a company to update its disclosure by describing only material developments that have occurred since its most recent full discussion of the general development of the business. If a company relies on this new accommodation, it must incorporate by reference the full disclosure from a single previously filed document and must include a single hyperlink to a registration statement or report that includes the full discussion. This new approach is more restrictive than existing rules governing incorporation by reference that, subject to certain limits, allow registrants to incorporate information by reference from more than one previously filed document. The new single hyperlink limitation will require companies that choose this option to include the full discussion for a subsequent update before they could again rely on the hyperlink accommodation in Item 101(a)(2). If a company does not choose this option, it must provide a complete discussion of its business development, including any material updates, in each filing.

Changes to Item 103 - Legal Proceedings

Item 103 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. Similar information must be provided for such proceedings known by the company to be contemplated by governmental authorities. The amended rule clarifies that companies are permitted to provide disclosure responsive to Item 103 by hyperlink or cross-reference to legal proceedings disclosure elsewhere in the document. To the extent a company takes this approach, it should ensure that disclosure provided elsewhere in the document includes all of the information required by Item 103 and supplement the cross-reference with additional disclosure if necessary.

Prior to the amendment, environmental proceedings involving the company must be disclosed if a governmental authority is a party and the proceeding involves potential monetary sanctions of less than $100,000. The amendments to Item 103 increase this disclosure threshold to $300,000. In addition, a company may elect to apply a different threshold that it determines is reasonably designed to result in disclosure of material environmental proceedings, provided that the threshold does not exceed the lesser of $1 million or one percent of the company’s current assets.

Changes to Item 105 - Risk Factors

The amendments to Item 105 reflect the SEC's concern about the length and complexity of risk factors provided by many companies. As amended, Item 105 will require companies to provide a summary of their principal risk factors if the full risk factor discussion exceeds 15 pages. The summary must consist of concise, bulleted or numbered statements and cannot be more than two pages long. When evaluating how to apply the new rules, companies with risk factor sections that are longer than 15 pages will need to weigh the perceived risks of eliminating or shortening risk factor disclosure, which they may feel provides important context and could help protect them from litigation, against the added burden of preparing the required summary.

In addition, companies will now be required to organize their risk factor disclosure under relevant headings, in addition to the sub-captions that are currently required. The amendments require companies to group generic risk factors together under a heading titled "General Risk Factors," which must appear at the end of the risk factor section. The revised rule does not further specify risk factor headings that companies should use.

The amended rule also will require disclosure of "material" risk factors, instead of the current requirement to provide a discussion of the "most significant" risk factors. In the adopting release, the SEC stated that this change should reduce the disclosure of generic risk factors and potentially shorten the length of the risk factor discussion. Choosing to eliminate a risk factor because it is only one of the "most significant" but not "material" will take careful analysis in consultation with outside counsel, as the boundaries between these two concepts are not cleanly drawn.

Foreign Private Issuers

The SEC did not amend the corresponding requirements for description of business or legal proceedings in Form 20-F, the annual report and registration form used by foreign private issuers, and those requirements remain the same. The amendment to Item 105 will affect both domestic and foreign companies because the registration and reporting forms used by foreign private issuers refer to that Item for risk factor disclosure.

Takeaways

The SEC's disclosure requirements are rooted in materiality and are designed to facilitate an understanding of each company's business, financial condition and prospects. By updating Items 101, 103 and 105, the SEC intends to elicit improved disclosure more specifically tailored to each company's business. The amendments also are intended to improve readability of disclosure documents, discourage repetition and reduce disclosure of information that is not material.

The amended rules generally give companies more flexibility in preparing their disclosures, and in some cases companies may be able to eliminate disclosures that are not material or that can be incorporated through cross-references or hyperlinks. However, the amended rules will require some companies to provide incremental disclosures, including disclosure related to human capital resources, governmental regulation, risk factors, and business strategy. These new disclosures must be carefully drafted in consultation with outside counsel and reviewed by relevant business lines.

If you have questions about how these new rules apply to your business, please contact your Proskauer attorney or one of the capital markets attorneys listed on this alert.

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