

SEC Proposes Updated Disclosure Rules for Business Description, Legal Proceedings and Risk Factors

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On August 8, the SEC proposed updated **rules** for the business description, legal proceedings and risk factor disclosures that U.S. companies make in registration statements, annual reports and quarterly reports. This proposal is part of the SEC's continuing effort to modernize disclosure requirements, and follows several recent initiatives, including those relating to MD&A and third-party financial statements, as summarized in our **memorandum** last March. The goal, mandated by Congress in 2012 and again in 2015, is to improve disclosure for investors while simplifying compliance requirements for companies.

Generally, we welcome the changes proposed to modernize disclosure and eliminate duplicative disclosures in public filings, although we do not expect the proposed rules, if adopted, to materially impact the disclosure requirements for SEC filings.

Comments on the proposal are due 60 days after publication of the proposal in the Federal Register.

Business Description – Regulation S-K Item 101

The proposed amendments to business-description requirements emphasize a principles-based, rather than prescriptive, approach and are intended to give the company more flexibility to focus on what is important or unique to it, and also reflect changes to the economy since the rules were first adopted.

“General development” of the business

The current rule includes a limited list of items required for disclosure about the general development of a registrant's business, including (i) bankruptcy proceedings, (ii) merger or consolidation and (iii) acquisition or disposition of material amounts of assets. The amendment would make this list non-exclusive, and proposes disclosure of a topic only to the extent such information is material to understanding the general development of the business.

The proposed rule would also add a fourth item for disclosure related to “transactions and events that affect or may affect the company's operations, including material changes to a previously disclosed business strategy.” Many companies discuss their strategies as part of their IPO registration statements. The SEC believes that if a strategy has previously been disclosed, changes to that strategy may be material to investors and therefore should be discussed in subsequent filings.

If there is material information beyond the four topics, the company would be required to disclose that as well. The proposal would also eliminate the required five-year timeframe and instead, companies would need to focus on the period over which information would be material, since a five-year timeframe may not elicit the most relevant disclosure for every company. In some cases, a period longer than five years might be appropriate, and in most cases, a shorter period would be better.

In addition, the proposal would permit a company to provide only an update of the general development of the business after its IPO filing, with an active hyperlink to the most recent filing that, together with the update, would contain the full discussion of the general development of the business.

“Narrative description” of the business

Currently the rule includes a long list of disclosure topics that are meant to provide a narrative description of the registrant’s current business. The SEC believes that many of these topics, such as disclosure of raw materials and backlog, are outdated in today’s economy. The proposed list would exclude from the current list disclosure about working capital practices (which would be covered in the MD&A), new segments, and dollar amount of backlog. However, if these topics are in fact material, the company would still need to provide disclosure about them. While the current rule does contain an explicit materiality standard, the SEC states that many registrants treat the list as mandatory and believes that shifting to a more principles-based framework will encourage companies to use their judgment to tailor the disclosure.

The principles-based requirements would include a list of disclosure topics, drawn from those in current Item 101(c) of Regulation S-K, that are likely to be material to many companies, retaining the current distinction between “segment disclosure topics” and “topics to be discussed in the context of the business as a whole”, as set forth below.

Segment Disclosure Topics

- **Revenue-generating activities, products and/or services, and any dependence on revenue-generating activities, key products, services, product families or customers, including governmental customers**

This item would combine two existing items in the current rule and adds disclosure of dependence on governmental customers.

- **Status of development efforts for new or enhanced products, trends in market demand and competitive conditions**

This item expands on current disclosure about new products to include competitive environment for the company

- **Resources that are material to the business, such as (i) sources and availability of raw materials, and (ii) duration and effect of all patents, trademarks, licenses, franchises and concessions held**

While intellectual property has become increasingly important to many companies, the SEC elected not to expand the topic to add copyrights or trade secrets. This item remains the same as the current rule.

- **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**
- **The extent to which the business is or may be seasonal.** The SEC retained this topic to avoid a potential loss of information about seasonality in the fourth quarter because GAAP may not elicit this disclosure. Given the requirement to include quarterly financial results in filings, it is not clear that there is utility to this requirement for most registrants.

Disclosure Topics Applying to the Company as a Whole

The two topics identified below are intended to be discussed in the context of the company as a whole, unless material to a particular segment, in which case the discussion should cover that segment as well.

- **Regulatory Compliance**

The proposal would expand the currently mandated disclosure regarding the material impact of environmental regulations to cover all material government regulations. A company would be required to disclose the material effects of compliance with government regulations on its capital expenditures, earnings and competitive position. As the SEC noted, while there is currently no

separate requirement to disclose material government regulations, many companies provide this type of disclosure, and therefore this requirement is consistent with current disclosure practices.

- **Human Capital**

This proposal would replace the existing requirement to disclose only the number of employees with a requirement to provide a description of the company's human capital resources, including any measures or objectives that management focuses on in managing the business. This may include, depending on the nature of the company's business and workforce, measures and objectives that address the recruitment, development and retention of personnel. The exact measures or objectives discussed in a company's disclosure may change over time and vary by industry.

The SEC asked for comments on whether it should add non-exclusive examples of measures or objectives that may be material, such as the number of full-time, part-time, seasonal and temporary workers; voluntary and involuntary turnover rates; measures regarding average hours of training per employee per year; information regarding human capital trends, such as competitive conditions and internal rates of hiring and promotion; measures regarding worker productivity; and management's progress with respect to any objectives it has set regarding human capital resources. For companies considering more disclosure regarding their human capital, this may be a starting list of items for consideration.

Changes to disclosure regarding human capital have been anticipated as the SEC has emphasized that the increasing importance of human capital relative to equipment and machinery is a shift in today's economy. The SEC notes the growing interest in human capital disclosure, and its stated intent is to elicit disclosures, to the extent material, regarding human capital that allow investors to understand and evaluate this resource and to see through the eyes of management how human capital is managed.

Legal Proceedings – Regulation S-K Item 103

The proposal would explicitly permit information about material legal proceedings to be provided by including hyperlinks or cross-references to disclosure located elsewhere in the document, such as the risk factor or business sections. In addition, the current \$100,000 threshold for disclosure of certain environmental proceedings would be increased to \$300,000.

Risk Factors – Regulation S-K Item 105

The current risk factor disclosure requirement is principles-based and mandates disclosure of "the most significant factors that make an investment in the registrant or offering risky."

The SEC believes that, over time, risk factor disclosure has become too lengthy and generic. The proposed amendment would retain the principles-based approach but slightly change the disclosure standard from the "most significant" to "material" factors, because "materiality" for disclosure is tied to what is important from the investor's perspective. In addition, the proposal would 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 under a separate caption. The proposal would also require summary risk factor disclosure if the risk factor section exceeds 15 pages.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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