

## SEC Updates Business, Legal Proceedings and Risk Factors Disclosure

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### New rules move from prescriptive to a more tailored approach

On August 26, the Securities and Exchange Commission (SEC) adopted **amendments** to update the business description, legal proceedings and risk factor disclosures that U.S. companies make in registration statements, annual reports and quarterly reports. In making these changes, the SEC is taking a more tailored and “principles-based” approach to disclosure, with the intention of simplifying compliance for companies and improving information provided to investors. While the new rules will eliminate the need for certain items of disclosure, the transition to the new disclosure rules may result in an initial burden as companies reconsider their current disclosure model.

The rules will go into effect 30 days after publication in the Federal Register.

#### Key takeaways:

- Required list of topics in description of business eliminated in favor of topics material to a company’s business
- Elimination of five-year timeframe in description of business
- Option to update for material developments in the general development of business rather than full discussion
- Inclusion of human capital resources disclosure
- Expansion of government regulation disclosure to include the material effects of compliance with *all* government regulations

### Business Description – Regulation S-K Item 101

#### Development of the Business (Item 101(a))

The final rules move away from a prescriptive approach to a more principles-based one, which will provide companies with flexibility to tailor disclosure to their unique circumstances. The rules replace the current prescribed list of topics with a non-exclusive list of topics that a company will be required to disclose to the extent that such topic is material to an understanding of the general development of the company’s business. Noting that many companies include strategy in the IPO registration statements, the SEC has included a new topic, “material changes to a previously disclosed business strategy,” in this list of topics.

- *Non-exclusive list of topics:* Under the new rules, Item 101(a) disclosure may include, but should not be limited to, the following topics:
  - any material changes to a previously disclosed business strategy;
  - the nature and effects of any material bankruptcy, receivership, or any similar proceeding with respect to the company or any of its significant subsidiaries;
  - the nature and effects of any 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 otherwise than in the ordinary course of business.
- *Elimination of five-year timeframe:* The new rules eliminate the five-year timeframe for disclosure and instead require disclosure of information material to an understanding of the general development of the business.
- *Update option:* For filings subsequent to an initial registration statement, a company may provide an update of the material developments in the general development of its business rather than a full discussion. If a company chooses to update, it must incorporate by reference the most recent full discussion of the general development of its business from a single previously filed document.

## Narrative Description of the Business (Item 101(c))

Like the changes to the development of business disclosure, the description of business disclosure has been revised to make it more principles-based by replacing the list of required topics with a non-exclusive list of disclosure topics. The list in the new rules is substantially drawn from the current list but eliminates certain topics the SEC found not to be relevant to all companies. However, under the principles-based approach, a company would still be required to provide disclosure on an eliminated topic, such as working capital, or any other topic regarding its business, if it was material to an understanding of its business. The new list retains the distinction between “segment disclosure topics” and “topics to be discussed in the context of the business as a whole.”

- *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.
  - Development: status of development efforts for new or enhanced products, trends in market demand, and competitive conditions. This is intended to elicit more granular information than the current requirement.
  - Resources: resources material to a company’s business, such as: (A) sources and availability of raw materials; and (B) the duration and effect of all patents, trademarks, licenses, franchises and concessions held.
  - Government contracts: 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: the extent to which the business is or may be seasonal.
- *Topics applying to company as a whole:*
  - Governmental regulation: This topic has been expanded to include the material effects that compliance with *all* government regulations, in addition to environmental regulations, may have upon the company’s capital expenditures, earnings and competitive position. In its release, the SEC noted that it intended to formalize the current practice of many companies that already make disclosure of the effects of compliance with laws and regulations on their business.
  - Human Capital Resources: The current requirement to disclose the number of persons employed has been expanded also to include, to the extent such disclosure is material to an understanding of the company’s business taken as a whole, a description of the company’s human capital resources, including measures or objectives that the company focuses on in

managing the business (such as, depending on the nature of the company's business and workforce, measures or objectives that address the development, attraction and retention of personnel). The SEC declined to define "human capital," recognizing that the term may evolve over time and may vary depending on the specific nature of the company. Instead, the new rule requires that the disclosure be tailored to the facts and circumstances of a company's business and workforce. While the final rule does not require companies to disclose any specific human capital metrics such as the number of part-time or full-time employees or workforce turnover, a company would be required to disclose such metrics if they are material to an understanding of its business.

## Legal Proceedings – Regulation S-K Item 103

The new rules raise the monetary threshold for disclosure of environmental legal proceedings to which the government is a party from \$100,000 to \$300,000. As an alternative, a company may use any threshold amount that it determines is reasonably designed to result in disclosure of material environmental proceedings. However, even if the company uses an alternative threshold, it must disclose any environmental proceedings in which the potential monetary sanctions exceed the lesser of \$1 million or 1% of its current assets. In addition, any company that uses a threshold other than \$300,000 will be required to disclose this threshold, and any changes to it, in its quarterly and annual filings.

## Risk Factors – Regulation S-K Item 105

The SEC's amendments to risk factor disclosure are aimed at reducing boilerplate and generic risks, including risk factors used by companies in a similar industry that have not been tailored to a company's specific risk profile. To that end, the new rules:

- change the standard of disclosure from the "most significant" risks to "material" risks;
- where a company's risk factors disclosure exceeds 15 pages, require a summary section consisting of a series of concise, bulleted or numbered statements summarize the principal factors that make the investment or offering speculative or risky; and
- require risk factors to be organized under relevant headings.

## Application to Foreign Private Issuers

The rule changes to Item 101 (business description) and Item 103 (Legal Proceedings) of Regulation S-K will not apply to foreign private issuers (FPIs), unless they have chosen to register securities on a domestic form, such as Form S-1. However, the changes to Item 105 (Risk Factors) will apply to FPIs because Forms F-1, F-3 and F-4 all refer to Item 105. To the extent that an FPI's annual report on Form 20-F is incorporated into its Form F-3 for purposes of updating the registration statement, the rule changes for Item 105 would apply as well.

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