

## **SEC Proposes to Modernize Disclosures of Business, Legal Proceedings and Risk Factors Under Regulation S-K**

### **I. Overview**

On August 8, 2019, the Securities and Exchange Commission (the “SEC”) issued a release (the “Release”)<sup>1</sup> proposing amendments to Regulation S-K Items 101, 103 and 105 in order to modernize the description of business, legal proceedings and risk factor disclosure requirements. The purposes of the amendments are to improve the readability of disclosure documents and to discourage repetition and disclosure of immaterial information.<sup>2</sup>

### **II. The SEC’s Approach to Disclosure Modernization**

Regulation S-K consists of line-item requirements to elicit specific disclosure with broad categories of information material to an investment decision. Some of these are principles-based requirements, which offer management the flexibility to evaluate the overall significance of such topics to a company and tailor disclosure to its specific business and financial circumstances. Other disclosure requirements are prescriptive in nature, including quantitative thresholds and specific bright-line rules that require all companies to disclose the same type of information. While more rigid in nature, prescriptive requirements offer comparability and consistency and are easier to apply. In the Release, the proposed Items 101 (description of the business) and 105 (risk factors) are more principles-based because current rules may not reflect what is material to every business and prescriptive rules in these areas can become outdated. In contrast, the SEC uses a prescriptive approach for Item 103 (legal proceedings) that depends less on characteristics specific to individual companies and allows for consistency across issuers.<sup>3</sup>

### **III. General Development of Business (Item 101(a))**

The existing Item 101(a) of Regulation S-K requires a description of general development of a company’s business during past five years, including the following specific disclosures: (i) the year and form of organization; (ii) any bankruptcy matter involving the company or its significant subsidiaries; (iii) any material reclassification, merger, consolidation of company of significant subsidiaries; (iv) any acquisition or disposition of a material amount of assets not in ordinary course of business; and (v) material changes in mode of conducting business.<sup>4</sup> The proposal would amend Item 101(a) to make it more principles-based by providing a non-exclusive list of the topics that companies may need to disclose if material to an understanding of the general development of a registrant’s business.<sup>5</sup> The list includes three topics covered by the current rule (i.e., clauses (ii), (iii) and (iv) discussed above), plus one new topic – transactions and events that affect the company’s operations, including material changes to a previously disclosed business strategy.<sup>6</sup> Additionally, instead of a prescribed five-year

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<sup>1</sup> For the full text of the release, see Securities and Exchange Commission, Modernization of Regulation S-K Items 101, 103, and 105, SEC Release Nos. 33-10668, 34-86614, available at <https://www.sec.gov/rules/proposed/2019/33-10668.pdf> (August 8., 2019).

<sup>2</sup> *Id.*, at 1.

<sup>3</sup> *Id.*, at 6-9.

<sup>4</sup> *Id.*, at 12, citing 17 CFR 229.101(a).

<sup>5</sup> *Id.*, at 18.

<sup>6</sup> *Id.*, at 18-19.

timeframe for the disclosure, each issuer would be required to focus on the information material to an understanding of the development of the business over the most relevant timeframe for that issuer.<sup>7</sup>

Complete descriptions of the general development of the business would be required only in initial registration under the Securities Act of 1933 and the Securities Exchange Act of 1934. In subsequent filings, companies would be required only to update their existing disclosures, focusing on any material developments in the reporting period. Companies would also be required to include an active hyperlink to the most recently filed disclosure that would present a full discussion of the general development of the business.<sup>8</sup>

#### **IV. Narrative Description of Business (Item 101(c))**

The existing Item 101(c) of Regulation S-K requires a narrative description “of the business done and intended to be done” by a company and its subsidiaries, focusing on the “dominant segment or each reportable segment for which financial information is presented in the financial statements.”<sup>9</sup> To the extent material a company’s business as a whole, the description of each such segment must include the following 10 items: (1) principal products and services, (2) the stage of its products and any new products, (3) sources and availability of raw materials, (4) intellectual property, (5) seasonality, (6) working capital practices, (7) dependence on certain customers, (8) dollar amount of backlog orders, (9) business subject to renegotiation or termination of government contracts and (10) competition. Additionally, with respect to the company’s business in general, the material effects of compliance with environmental laws and the number of employees must also be disclosed.<sup>10</sup> The proposed rule would clarify and expand the principles-based approach, with disclosure topics drawn from a subset of topics currently in Item 101(c).<sup>11</sup>

The proposed Item 101(c) would include a non-exclusive list of disclosure topics that the SEC believes would likely be material to many companies, while leaving flexibility for companies to tailor disclosure to their specific circumstances. Rather than line-item requirements, the proposed topics would need to be disclosed for each segment only when material to an understanding of the company’s business taken as a whole. Likewise, topics that would no longer be explicitly listed in Item 101(c) (i.e., disclosure of working capital practices, the status of new products and segments and the dollar amount of backlog orders) would still need to be disclosed, along with any other topics, when material to an understanding of the company’s business.<sup>12</sup>

Below is an overview of the proposed disclosure topics that would be required with respect to each segment when material to an understanding of the company’s business taken as a whole, including notes on any key changes:<sup>13</sup>

1. *Revenue-generating activities, products and/or services, and any dependence on key products, services, product families, or customers, including governmental customers* – These would remain topics to be disclosed to the extent material.<sup>14</sup>

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<sup>7</sup> *Id.*, at 15.

<sup>8</sup> *Id.*, at 16-17.

<sup>9</sup> *Id.*, at 22, citing 17 CFR 229.101(c).

<sup>10</sup> *Id.*, at 22-23, citing 17 CFR 229.101(c).

<sup>11</sup> *Id.*, at 10.

<sup>12</sup> *Id.*, at 26-27.

<sup>13</sup> *Id.*, at 27-28.

<sup>14</sup> *See id.*, at 28.

2. *The status of developing efforts for new or enhanced products, trends in market demand and competitive conditions* – The proposed rule would leave flexibility to disclose this information to the extent material to better accommodate differing competitive landscapes.<sup>15</sup>
3. *Resources material to a registrant’s business* – The current rule requires specific disclosure of the sources and availability of raw materials and the importance, duration and effect of all patents, trademarks, license, franchises and concessions held, to the extent material to the business. The new rule would instead emphasize all resources material to the business, and include the aforementioned items only as examples of resources that may be material.<sup>16</sup>
4. *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* – This would remain a listed topic under the proposed rule, as the SEC continues to believe that disclosure of this information is important for investors when material to a business.<sup>17</sup>
5. *The extent to which the business is or may be seasonal* – While the SEC had considered deleting this topic, the proposed rule would retain it due to the concern that the potential loss of information in the fourth quarter about the extent to which a company’s business or its segment may be seasonal as U.S. GAAP may not elicit this disclosure.<sup>18</sup>

The following two disclosure topics would apply if material to the business taken as a whole, and companies would also need to identify any particular segment for which these topics are material. These topics are more expansive than those found in the current rules, as the SEC believes investors may benefit from additional information.<sup>19</sup>

1. *Compliance with material government regulations, including environmental regulations* – The existing rule specifically requires disclosure of the material effects of compliance with environmental laws on a company and its subsidiaries’ capital expenditures, earnings and competitive position.<sup>20</sup> The proposed rule would instead require the disclosure to include the material effects of compliance with any material government regulations, not just environmental laws. The SEC believes this approach would allow a company to tailor its disclosure to those regulations particularly important to its business, and noted that it has already become common practice for companies to broadly disclose material regulations under this topic.<sup>21</sup>
2. *Human capital disclosure* – While the current rule requires disclosure of the number of persons employed by a company, the proposed rule would instead require a description of the company’s human capital resources, including any human capital measures or objectives that management

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<sup>15</sup> See *id.*, at 29.

<sup>16</sup> See *id.*, at 29-30.

<sup>17</sup> See *id.*, at 37.

<sup>18</sup> See *id.*, at 38.

<sup>19</sup> See *id.*, at 27-28, 38-49.

<sup>20</sup> See *id.*, at 39.

<sup>21</sup> See *id.*, at 40-43.

focuses on, to the extent material to an understanding of the business. The purpose of this change is to modernize disclosure to reflect that human capital may represent an important resource and driver of performance for certain companies. The proposed rule provides non-exclusive examples of human capital measures and objectives that may be material, including those that address the attraction, development and retention of personnel.<sup>22</sup>

## V. Legal Proceedings (Item 103)

The existing Item 103 of Regulation S-K requires disclosure of certain information related to any material pending legal proceedings, other than routine litigation incidental to the business, involving a company, any of its subsidiaries or any of their property. Proceedings known to be contemplated by governmental authorities must be disclosed.<sup>23</sup> Despite considering the possible modification or elimination of the disclosure currently required by Item 103 in a prior release, the SEC decided to maintain the disclosure requirements in Item 103 in response to concerns expressed by commenters, with only two minor amendments.<sup>24</sup>

First, the proposed Item 103 expressly provides for the use of hyperlinks or cross-references to avoid repetitive disclosure. To avoid repeating information included elsewhere in the document (e.g., the notes to the financial statements under U.S. GAAP, the MD&A and the Risk Factors sections), under the proposed Item 103, some or all of the required information may be provided by including hyperlinks or cross-references to legal proceedings disclosure included elsewhere in the document.<sup>25</sup>

Second, the proposed Item 103 would raise the threshold for the disclosure of environmental proceedings to which the government is a party. Although the SEC had considered a materiality threshold for this topic, the SEC continues to believe that a disclosure threshold based on imposition of a governmental fine is the right approach because (i) investors may find such a fine significant in evaluating a company's compliance with environmental laws and (ii) it provides a useful benchmark for determining whether complex environmental proceedings should be disclosed. The SEC has proposed raising the threshold from \$100,000, adopted in 1982, to \$300,000 to adjust for inflation.<sup>26</sup>

## VI. Risk Factors (Item 105)

The existing Item 105 of Regulation S-K requires disclosure of the most significant factors that make investing in a company or offering risky and calls for the discussion to be concise and organized logically. Additionally, Item 105 directs companies to explain how each risk affects the company or securities offered, discourages disclosure of generic risks not specific to the company and requires each risk to be described under a subheading adequately describing the risk.<sup>27</sup> Three changes have been proposed to Rule 105 to address the lengthy and generic risk factors disclosed by many companies, which the SEC believes adds complexity, without necessarily providing useful information.<sup>28</sup>

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<sup>22</sup> See *id.*, at 44, 48.

<sup>23</sup> *Id.*, at 54, citing 17 CFR 229.103.

<sup>24</sup> *Id.*, at 56-57.

<sup>25</sup> *Id.*, at 57-58.

<sup>26</sup> *Id.*, at 62-63. The SEC estimated that \$100,000 from the May 1981 proposing release would be \$285,180.40 as of May 2019, and rounded up.

<sup>27</sup> *Id.*, at 64-65, citing 17 CFR 229.105.

<sup>28</sup> *Id.*, at 65, 68.

The first change would require summary risk factor disclosure if the risk factor section exceeds 15 pages. The SEC considered imposing a page limit on risk factor disclosure, but decided against it due to concerns raised by commenters. Instead, if the risk factor disclosure exceeds 15 pages, the proposed rule would require a summary risk factor disclosure section towards the beginning of the document, consisting of a short bulleted list summarizing the principal risk factors. The SEC believes a 15-page threshold may provide an incentive to shorten risk factor disclosure and would affect approximately 40 percent of current filers. If a company needs to exceed 15 pages, the SEC thinks that summary risk factor disclosure at the beginning of the document would enhance the readability and usefulness of such disclosure.<sup>29</sup>

The second change would replace the requirement to disclose the “most significant” risks with “material” risks. The SEC hopes the revised rule will focus companies on disclosing only those risks to which reasonable investors would attach importance in making investment decisions. Moreover, the SEC believes this will result in risk disclosure that is more tailored to each company’s particular circumstances, reduce the disclosure of immaterial risks and potentially shorten risk factor disclosure.<sup>30</sup>

The third change would require companies to organize risk factors under relevant headings to help readers comprehend lengthy risk factor disclosures. Further, if a company chooses to disclose risks that could apply to other companies or securities offerings without providing an explanation of why such risks are particularly relevant to an investor in its securities, the proposed rule would require such risk factors to be located at the end of the risk factor section under the caption “General Risk Factors.”<sup>31</sup>

## VII. Conclusion

The proposed amendments to Regulation S-K Items 101, 103 and 105 are a continuation of the SEC’s broader disclosure effectiveness initiative to evaluate the information that must be disclosed under the current rule, how and where this information is presented and how the SEC can modernize the rules using available technology. The SEC believes that the amendments proposed in the Release will benefit investors and companies by improving the readability of disclosure documents and discouraging repetition and disclosure of immaterial information. The SEC is seeking comments on the release until October 22, 2019.<sup>32</sup>

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Helene R. Banks at 212.701.3439 or [hbanks@cahill.com](mailto:hbanks@cahill.com); Bradley J. Bondi at 202.862.8910 or [bbondi@cahill.com](mailto:bbondi@cahill.com); Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Geoffrey E. Liebmann at 212.701.3313 or [gliebmann@cahill.com](mailto:gliebmann@cahill.com); Ross Sturman at 212.701.3831 or [rsturman@cahill.com](mailto:rsturman@cahill.com); or David A. Rand at 212.701.3189 or [drand@cahill.com](mailto:drand@cahill.com).

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<sup>29</sup> *Id.*, at 67-69.

<sup>30</sup> *Id.*, at 69-70.

<sup>31</sup> *Id.*, at 70-72.

<sup>32</sup> *Id.*, at 1, 4.