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SEC/CORPORATE

SEC Proposes to Modernize Business, Legal Proceedings and Risk Factor Disclosures Required by Regulation S-K

On August 8, the Securities and Exchange Commission proposed amendments to modernize the required disclosures under Regulation S-K regarding a company's business description, legal proceedings and risk factors (the Proposal). The Proposal is part of the Staff's disclosure effectiveness initiative to improve its disclosure regime for investors and registrants. The Proposal would implement a more principles-based approach with respect to the disclosure rules relating to the registrant's business description and risk factors. The SEC notes that its aim for using such an approach, as opposed to prescriptive requirements, would be to "elicit more relevant disclosures" about the items because the current requirements "may not reflect what is material to every business." The following are key elements of the proposed amendments.

Item 101(a) – Description of the General Development of the Business. In general, Item 101(a) currently requires a registrant to provide a description of the general development of its business during the past five years (or, if shorter, the period it has been engaged in business). In an effort to provide flexibility for a registrant to tailor its disclosures to its particular circumstances, the proposed amendments to Item 101(a) would:

- Provide a non-exclusive list of the types of information that a registrant may need to disclose, requiring disclosure of a topic only to the extent such information is material to an understanding of the general development of a registrant's business. The non-exclusive list of disclosure topics would include the following (the final three of which are currently covered in Item 101(a)(1)):
    - transactions and events that affect or may affect the company's operations, including material changes to a previously disclosed business strategy ((which business strategy related disclosure is not required by current disclosure rules); provided, that if a registrant has not previously disclosed a business strategy, such disclosure would not be mandatory;
    - bankruptcy, receivership or any similar proceeding;
    - the nature and effects of any material reclassification, merger or consolidation of the registrant 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.
- Eliminate the currently prescribed five-year timeframe for the disclosure (because the material aspects of a registrant's business development may cover a longer or shorter period); and
- Permit a registrant, in filings made after an initial registration statement or other filing, to provide only an update of the general development of the business that focuses on any material developments in the reporting period, along with an active hyperlink to the registrant's most recent filing that, together with the update, would contain the full discussion of the general development of the business.

Item 101(c) – Narrative Description of Business. Item 101(c) requires a registrant to provide a narrative description of business done by it and its subsidiaries, broken into reportable segments (as applicable), and addressing, to the extent material to an understanding of the registrant's business, 10 specifically identified items as applied to each segment, as well as two additional items to be discussed with respect to the registrant's business in general. The SEC noted that the specific items listed may not be relevant to all registrants and that some registrants interpreted Item 101(c) as requiring disclosure of all of the items, resulting in disclosure that is not material to a particular registrant. Moving toward a more principles-based approach would, the SEC explained,

"encourage registrants to exercise judgment in evaluating which disclosure to provide, which would result in disclosure more appropriately tailored to a registrant's specific facts and circumstances." The proposed amendments to Item 101(c) would:

- include a non-exclusive list of disclosure topics, drawn from a subset of the topics currently contained in Item 101(c), including:
    - revenue-generating activities, products and/or services, and any dependence on revenue-generating activities, key products, services, product families or customers, including governmental customers;
    - status of development efforts for new or enhanced products, trends in market demand and competitive conditions;
    - resources material to a registrant's business, such as 1) sources and availability of raw materials; and 2) the duration and effect of all patents, trademarks, licenses, franchises and concessions held;
    - 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; and
    - the extent to which the business is or may be seasonal.

  In addition, Item 101(c) would no longer include disclosure topics regarding working capital (which the Staff expects would be discussed in a registrant's MD&A, to the extent material), new segments and the dollar amount of backlog orders believed to be firm. The Proposal would retain the distinction between disclosure topics for which segment disclosure should be the primary focus, as compared to those for which the focus should be the business as a whole.

- replace the current requirement to provide disclosure of the number of persons employed with a requirement to disclose, to the extent material, a registrant's human capital resources, including any human capital measures or objectives that management focuses on in managing the business, such as measures or objectives that address the attraction, development and retention of personnel; and
- refocus the regulatory compliance requirement by including material government regulations, not just environmental provisions, as a topic (which broader regulatory compliance disclosure many registrants already include, notwithstanding that such disclosure is not specifically referenced in the current Item).

Item 103 – Legal Proceedings. Item 103 presently requires a registrant to disclose any material legal proceedings, other than routine litigation incidental to the business to which it or its subsidiaries are a party, as well as details regarding the court or agency in which the proceedings are pending, date instituted and factual description of the dispute. Item 103 also requires a registrant to disclose any proceeding under environmental laws to which a governmental entity is a party unless a registrant believes it will not result in sanctions of $100,000 or more. In contrast to the principles-based approach reflected in the amendments to Item 101(a) and Item 101(c) described above, the Proposal would retain Item 103's prescriptive approach, with the Staff noting that the legal proceedings disclosure requirement is less dependent on specific characteristics of individual registrants. Specifically, the proposed amendments to Item 103 would:

- revise the current $100,000 threshold for disclosure of environmental proceedings to which the government is a party to $300,000 to adjust for inflation; and
- noting the overlap, in part, of disclosure requirements with generally accepted accounting principles (US GAAP) and in an effort to encourage registrants to avoid duplicative disclosure, expressly permit required information about material legal proceedings to be provided by including hyperlinks or cross-references to legal proceedings disclosure located elsewhere in the document.

Item 105 – Risk Factors. Item 105 requires a registrant to disclose the most significant factors that make an investment in it or an offering speculative or risky for a potential investor. As mentioned above, the proposed amendments to Item 105 would further emphasize a principles-based approach to this disclosure, with the SEC noting in the Proposal that some registrants were not tailoring risk factor disclosure to their particular circumstances. Specifically, the proposed amendments to Item 105 would:

- require summary risk factor disclosure if the risk factor section exceeds 15 pages;
- revise the disclosure standard from the "most significant" factors to the "material" factors required to be disclosed, which the SEC believes may result in more tailored, and less immaterial, risk factor disclosure; and

- consistent with a practice that many registrants already follow, require risk factors to be organized under relevant headings, with any risk factors that may generally apply to other companies or an investment in securities, without explanation of why the identified risk is specifically relevant, to be disclosed at the end of the risk factor section under the caption "General Risk Factors."

The Proposal will be subject to a 60-day public comment period following publication in the *Federal Register*.

The SEC's press release is available here.

EU DEVELOPMENTS

European Commission Publishes Communication on Its Equivalence Policy With Non-EU Countries

On July 29, the European Commission (EC) published a communication on equivalence in the area of financial services (Communication). The EC states that, in light of recent policy developments, it is timely to take stock of the EU's approach to equivalence.

The Communication discusses the purpose and importance of equivalence. The EC states that each new decision is looked at individually and in detail to ensure that the policies of third countries are compatible with those of the EU, and that any equivalence determination is beneficial to, and sustainable for, both parties. EU financial services law includes approximately 40 provisions that allow the EC to adopt equivalence decisions and as of July 29, the EC has adopted more than 280 equivalence decisions for more than 30 countries.

The EC also highlights its recent improvements to the EU equivalence rules. The Communication states that the EC has engaged in a robust dialogue with the European Parliament, the Council of the EU and other interested stakeholders on the necessary improvements to the EU's approach to determining and maintaining equivalence. Significant changes have been introduced into the equivalence regimes through a number of legislative amendments relating to the proposed:

- Omnibus Regulation relating to the powers, governance and funding of the European Supervisory Authorities (ESAs), where the role of each ESA in monitoring equivalent third countries is enhanced;
- regulation amending the European Market Infrastructure Regulation (EMIR) supervisory regime for EU and third-country central counterparties (EMIR 2.2), where a more risk-sensitive and proportionate approach for third-country regimes is being introduced; and
- Investment Firms Directive, where new assessment criteria, safeguards and reporting obligations for third-country firms are being created."

In making equivalence assessments, the EC states that it is particularly concerned with identifying risks to the EU financial system. It also notes that equivalence empowerments do not confer a right on third countries for their frameworks to be assessed and that adhering to international standards does not automatically lead to an equivalence decision.

The EC indicates that in the forthcoming months it will work closely with the ESAs on their goals for 2019 and 2020, including:

- continuing work on equivalence assessments, especially relating to the Benchmarks Regulation;
- repealing existing decisions where the third-country framework no longer delivers the necessary outcomes (for example, under the Credit Rating Agency (CRA) Regulation—the EC announced that existing CRA equivalence decisions for Argentina, Australia, Brazil, Canada and Singapore have been repealed.);
- focusing on high-impact areas and third countries (EMIR is mentioned in this regard);
- focusing on areas where there is an impending review or expiry of an equivalence deadline (the Capital Requirements Regulation is mentioned in this regard); and
- examining market segments that are undergoing dynamics or structural changes (the Markets in Financial Instruments Regulation (MiFID II) is mentioned in this regard).

The Communication is available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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