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SEC Proposes Streamlining Disclosure Requirements

Proposal Contains Mostly Technical Changes With Limited Impact on the Substance of Required Disclosures

In a 318-page release published on July 13, 2016 and linked here, the SEC is proposing a number of technical amendments to disclosure requirements for SEC filers that it believes have become outdated or are identical or similar to overlapping requirements contained in other SEC rules, US GAAP or IFRS. The release is also soliciting comment on whether some disclosure requirements that overlap with US GAAP but require incremental information should be eliminated or referred to the FASB for potential incorporation into US GAAP. This is the first rule proposal that the SEC has issued as part of its ongoing disclosure effectiveness review. Comments on the release will be due 60 days after its publication in the Federal Register, which should occur shortly. Disclosure requirements will not change until the SEC adopts final rules.

Redundant or Duplicative Requirements

The SEC's disclosure rules are primarily contained in Regulation S-X, which deals with disclosures in financial statements, and Regulation S-K, which addresses disclosures in the non-financial part of SEC filings, such as the business section, MD&A and risk factors. In the release, the SEC proposes to eliminate several S-X requirements because they are substantially identical to financial statement disclosures required by US GAAP or IFRS. Examples include requirements relating to foreign currency disclosure, consolidation, changes in issued debt, income tax rate reconciliation, related party transactions, material contingencies, and EPS, among others. The SEC reasons that eliminating these duplicative requirements would simplify compliance. There would be no substantive changes in the financial statement disclosures as a result of these proposed eliminations.

Overlapping Requirements

- ***Proposed Deletions***. The SEC proposes deleting disclosure requirements that, although not identical, are reasonably similar to overlapping US GAAP, IFRS, or other disclosure requirements or require disclosure that the SEC believes is no longer useful to investors. We summarize most of the changes below.
  - *Financial Statement Disclosures*. The SEC proposes to delete a number of S-X requirements that it regards as substantially similar to disclosures required by US GAAP and, in one instance, in the MD&A. Examples include disclosures about repurchase and reverse repurchase agreements, derivative accounting, pro forma information in interim financial statements in connection with business combinations and dispositions, among many others. In addition, for REITs, the SEC proposes to eliminate disclosures about REIT status in the financial statements because they are covered in S-K disclosure.

- *Non-Financial Statement Disclosures*. The SEC proposes to delete requirements for disclosures in the business section about segment financial information and performance, geographic areas, including foreign operations, and seasonality, all in reliance on similar disclosures required in the financial statements and MD&A. In addition, the SEC proposes to remove S-K and 20-F requirements to disclose information about research and development in reliance on similar disclosures required in the financial statements under US GAAP or IFRS.
- *Compensation Plan Disclosures*. The proposal would eliminate the table currently required in 10-Ks (or forward-incorporated from the proxy statements) for existing equity compensation plans with equity securities authorized for issuance in reliance on similar disclosures required in the financial statements under US GAAP. Proxy disclosures about equity compensation plans submitted to shareholders for approval would not change.
- *Ratio of Earnings to Fixed Charges*. The SEC also proposes removing the requirements for issuers of registered debt securities to disclose a ratio of earnings to fixed charges and for issuers of registered preferred equity securities to disclose a ratio of dividends to earnings. The release points out that many of the components of these ratios are included or can be derived from the financial statements.

- ***Proposed Integrations***. The SEC proposes integrating various overlapping disclosure requirements. The proposal would streamline the disclosure requirements about restrictions on dividends that are currently in various places into a single comprehensive requirement in the financial statements. Another change would eliminate the need to discuss expected changes in geographic performance in the business section and would instead add a specific reference to geographic areas to the required disclosure in the MD&A.
- ***Potential Modifications, Eliminations, or FASB Referrals***. The release is also soliciting comment on some SEC disclosure requirements that overlap with US GAAP but require incremental information. The SEC is asking whether those requirements should be retained, modified or eliminated or referred to the FASB for potential incorporation into US GAAP. The release indicates that the SEC staff has discussed these overlapping requirements with the FASB staff.
  - *Financial Statement Disclosures*. A number of the SEC requirements that overlap with disclosures required by US GAAP are contained in Regulation S-X and thus relate to the content of the financial statements. Examples include consolidation matters, discounts on shares, assets subject to lien, defaults and matters relating to financing arrangements, related parties, repurchase and reverse repurchase agreements, and some disclosures in interim financial statements, among others.
  - *Products and Services and Major Customers*. Disclosure about revenue from products and services is currently required by S-K in the business section and by US GAAP in the financial statements, although at different thresholds. S-K requires this disclosure for any class of similar products or services which accounted for 10% or more of consolidated revenue in any of the last three fiscal years. US GAAP requires it for each product or service, or groups of similar products or services, unless impracticable. Similarly, both S-K and US GAAP currently require disclosures about major customers, but at different thresholds and with differences in the amount of required disclosure. S-K requires disclosure if loss of a customer, or a few customers, would have a material impact on a segment. US GAAP requires disclosure for each customer that comprises 10% or more of consolidated revenue, but without naming the customer. S-K requires the issuer to name any customer that represents 10% or more of consolidated revenue and whose loss would have a material adverse effect.

- *Legal Proceedings*. As we had pointed out in our comment letter on the SEC staff's disclosure effectiveness initiative, there are similarities between the litigation disclosures required by S-K Item 103 and those required by US GAAP. The SEC notes in the release that in their litigation disclosures issuers often repeat or cross-reference the corresponding information in the financial statements. However, the release also points out several differences in the criteria for disclosure of legal proceedings. For example, S-K exempts ordinary routine litigation from disclosure, while US GAAP does not. US GAAP is also more expansive in disclosure requirements for proceedings involving related parties. There are further differences in the disclosures required with respect to environmental matters and with respect to materiality and probability considerations. On page 101, the release includes a useful table detailing these and other differences.

Outdated and Superseded Requirements

The SEC identifies and proposes amendments to and deletions of disclosure requirements that have become obsolete as a result of the passage of time or changes in the regulatory, business, or technological environment. For example, the proposal would delete references to the SEC's Public Reference Room, replace detailed disclosure requirements for most issuers on the trading of their stock with the disclosure of the trading market and ticker symbol, and delete requirements relating to disclosure of readily available foreign exchange data. For IPOs by foreign private issuers, the proposed changes would permit using annual financial statements that are older than 12 months but not older than 15 months without the need for a waiver from the SEC staff. The SEC also proposes to update some disclosure requirements to reflect more recently updated other disclosure requirements, or more recently updated US GAAP requirements, for example, deleting references to the obsolete concepts of extraordinary items and cumulative effect of a change in accounting principle, among many others.

Potential Implications of Proposed Changes

While many of the proposed changes are mere clean-up in the SEC's rules that will have no or little substantive impact on disclosures, others could affect public company reporting and auditing in several ways. The SEC highlights the following considerations in its release.

- ***Disclosure Location.*** Some of the proposed changes would result in a relocation of disclosure within filings, often from the non-financial portion of the filing in the business description or MD&A to the financial statements. The SEC notes that changing the location of disclosure may change the prominence and/or the context of the disclosure, potentially impacting investors' review and perception of that disclosure.
- ***Auditor Involvement and Internal Controls***. If the relocation moves disclosure into or out of the financial statements, it would change whether such disclosure is subject to an annual audit or interim review by the issuer's auditors and to internal control over financial reporting. Greater reliance on financial statement disclosure may impact audit procedures and audit costs as well as the design and testing of internal controls.
- ***Forward Looking Statements Safe Harbor***. Whether disclosure is contained in financial statements or in non-financial disclosure would affect the availability of the Private Securities Litigation Reform Act safe harbor for forward-looking statements. The safe harbor is not available for financial statement disclosures. The SEC queries whether the absence of safe harbor protection may discourage issuers from providing supplemental forward-looking information with respect to disclosure requirements relocated to the financial statements.

- ***Bright-Line Disclosure Thresholds***. Some of the proposed changes implicate overlapping or similar disclosure requirements that differ due to the fact that one set of requirements includes a bright line disclosure threshold, such as a dollar amount or a percentage, while the other does not. The SEC notes that elimination or addition of a bright line test in certain circumstances may both change disclosure burdens on issuers and the level of disclosure to investors.
- ***Materiality Considerations***. As part of its Disclosure Framework project, the FASB has recently proposed clarifications to the concept of materiality under GAAP and its application to financial statement disclosures. A relocation of disclosures to the financial statements pursuant to a potential incorporation of some incremental requirements into US GAAP should also be considered in the context of these pending FASB proposals.
- ***Smaller Reporting Companies***. Because US GAAP, unlike the SEC's rules, does not have scaled disclosure requirements for smaller reporting companies, the SEC notes that relocating requirements to US GAAP may result in additional disclosure obligations for those companies.

Conclusion

In this very detailed release, the SEC is proposing a number of changes to update and streamline disclosure requirements. The SEC laudably aims to improve information available for investors while simplifying compliance by issuers, without significantly altering the total mix of information. Although the effort to review existing rules and identify these proposed changes must have been significant, many represent clean-up that will have little substantive impact. Others, especially the potential incorporation of SEC disclosure requirements into US GAAP, may require further analysis. If you have any questions about the release or would like to discuss or otherwise provide input on the proposals, please feel free to reach out to any of your Shearman & Sterling contacts below.

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