

# Proposed Rules Convey Shift In SEC's Disclosure Approach

By Robert Loesch and Daniel Schiau (September 11, 2019)

Since its adoption in 1977, Regulation S-K has remained largely stagnant in its prescription for disclosure. While the disclosure requirements were once sensible in light of the economic reality of the late 20th century, the ever-changing economy of recent decades, in part reactionary to the increased emphasis on technology, has forced policymakers to revisit the effectiveness of disclosure under the regulation.



Robert Loesch

On Aug. 8, after soliciting comments and conducting studies on the Regulation S-K disclosure requirements, the U.S. Securities and Exchange Commission proposed rule changes **to modernize** Items 101 (description of business), 103 (legal proceedings) and 105 (risk factors) of Regulation S-K.

The proposed rule changes seek to modernize the disclosures required under these items. While the SEC makes clear that the goal is still to require disclosure of information that is material to an investment decision, the amendments emphasize the SEC's desire to adopt a principles-based approach to the extent possible. As opposed to a prescriptive approach, which requires specific information to be disclosed regardless of management's view of its significance, a principles-based approach sets forth a disclosure concept and relies on a company's management to pass judgment on whether the requested information is significant in light of the registrant's business operations and financial circumstances.



Daniel Schiau

## Item 101(a): General Development of Business

Item 101(a) currently requires a description of the development of the registrant's business during the previous five years — or less, if the organization has not been in existence for five years. To implement a principles-based approach, the SEC has proposed eliminating the time frame in which a registrant must describe the development of its business, allowing the registrant instead to provide any information deemed material to an overall understanding of such development.

Additionally, under the proposed changes, Item 101(a) would allow for updates from previously filed information describing a company's business, with a hyperlink to the full description in prior filings.

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

Item 101(c) currently requires that a registrant provide a description of its business and that of its subsidiaries. According to the SEC, the intent of current Item 101(c) presently aligns with the SEC's desired principles-based approach.

However, current Item 101(c) has caused confusion by providing 12 topics of information that should be discussed if deemed material to a registrant's business taken as a whole, a requirement that is often misconstrued by registrants to require disclosure regardless of materiality or significance to the registrant's business. Not only would the proposed changes clarify that this information should be provided only if it is material to an understanding of a

registrant's business taken as a whole, the changes would also revise the topics to align them with typical investor expectations in 2019.

A few changes are noteworthy. First, the SEC proposes to broaden the general disclosure of the number of employees to an overarching description of the registrant's human capital resources, including any particular human capital measures or objectives used by management in the operation of the registrant's business.

Second, the SEC proposes to clarify that the disclosure of certain intellectual property deemed material to a registrant's business does not require disclosure of copyrights or trade secrets, unless the registrant has already disclosed this information voluntarily in prior filings.

Finally, the SEC proposes to amend the disclosure of the material effects of compliance with environmental laws to include all material governmental regulations, believing that this change will reflect any industry differentiation between registrants.

### **Item 103: Legal Proceedings**

Current Item 103 requires the disclosure of any material legal proceedings — excluding routine litigation incidental to the business — in which the registrant or any subsidiary is a party, or to which any of their property is subject. Unlike the other proposed amendments, the SEC has opted to proceed with a prescriptive approach in revising Item 103, as litigation is an inherent risk of operating any business and therefore industry differentiation is not a concern.

The SEC proposes two changes to current Item 103. First, the proposed amendment to Item 103 expressly permits some or all of the information required under Item 103 to be provided via hyperlinks or cross-references. Additionally, the SEC proposes to increase the monetary threshold from \$100,000 to \$300,000 for environmental claims.

### **Item 105: Risk Factors**

Item 105 currently requires each registrant to disclose the most significant factors in making an investment in a registrant or participation in an offering speculative or risky. Item 105 already utilizes a principles-based approach by giving registrants latitude in determining which factors are most significant.

However, in recent years, numerous registrants have been exceptionally verbose in their description of risk factors. One study found that word counts in Item 105 have increased by more than 50% between 2006 and 2014. To increase efficiency in the preparation and use of these disclosures, the SEC has opted to clarify further the requirements of Item 105.

As proposed, new Item 105 would permit registrants whose risk factors sections exceed 15 pages to provide summary risk factor disclosures consisting of a bulleted or numbered list of short, concise statements summarizing the factors that make investment in the registrant or participation in the offering risky.

Additionally, the amendment would revise the requirement that each registrant disclose only the most significant risks to instead require disclosure of only material risks, which are matters in which there is a "substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security."

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Robert Loesch is a partner and Daniel Schiau is an associate at Tucker Ellis LLP.

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