COVINGTON

SEC Updates Business, Legal Proceedings and Risk Factor Requirements of Regulation S-K

August 31, 2020

Securities and Capital Markets

On August 26, 2020, the Securities and Exchange Commission (SEC) adopted amendments to the business (Item 101), legal proceedings (Item 103) and risk factor (Item 105) disclosure requirements of Regulation S-K. These amendments are part of the SEC's ongoing Disclosure Effectiveness Initiative, the goal of which is to modernize the business and financial disclosure requirements of Regulation S-K, Regulation S-X, and related rules and forms.

The amendments generally seek to replace prescriptive disclosure requirements with a more principles-based disclosure framework. The amendments also add a new principles-based disclosure requirement relating to human capital resources. Because the amended disclosure requirements are principles-based, they will demand greater exercise of materiality judgments by companies in crafting disclosures that describe the development of, and risks associated with, their specific businesses. The amendments were originally proposed in August 2019 and were adopted largely as proposed with certain modifications.

1 Item 101(a) — General Development of Business

Item 101(a), which requires a general description of a public company's business, has been amended to eliminate many of the specifically enumerated disclosure requirements in favor of materiality and principles-based requirements.

- ***Current rule requirements***. Item 101(a) currently requires that companies provide a general business description covering the past five years, or such shorter period as the company may have been engaged in business. The item also requires information to be disclosed for earlier periods if material to an understanding of the general development of the business. Item 101(a) requires disclosure of certain other information, including the year that the company was organized, its form of organization and any material changes in the company's mode of conducting business. Item 101(h), the corresponding disclosure requirement for smaller reporting companies, requires a less detailed description than that required by Item 101(a), but still requires a description of the development of the company's business over the past three years.
- ***Amended rule requirements***. As amended, Item 101(a) no longer requires disclosure of many prescribed topics and instead calls for disclosure of business developments only to the extent such information is material to an understanding of a company's business, without reference to a specific timeframe.

- Amended Item 101(a) now includes a non-exclusive list of the types of information that a company may need to disclose. The non-exclusive list retains many of the existing disclosure topics, adds a new topic and eliminates the topic relating to disclosure of events or transactions that currently or may affect the company's operations, which was determined to be redundant in light of the similar disclosure requirement in management's discussion and analysis of financial condition and results of operations (MD&A) (Item 303).[1]
- The amended rule no longer mandates a five-year disclosure timeframe, or a three-year disclosure timeframe for smaller reporting companies, and instead applies a materiality standard to all of a company's general business description disclosures.
- Amended Item 101(a) permits a company, in subsequent filings after its initial registration statement, to provide an update on the general development of the business, rather than a full discussion. The update must disclose all of the material developments that have occurred since the company's most recent registration statement or periodic report containing a full discussion of the general development of its business, and incorporate by reference that prior discussion.

2 Item 101(c) — Narrative Description of Business

Item 101(c), which requires a narrative description of a public company's business, has been amended to incorporate a more principles-based approach.

- ***Current rule requirements***. Item 101(c) currently lists 10 specific items to be disclosed for the company's dominant segment, or each reportable segment, if material to an understanding of the company's business as a whole, and two items that must be disclosed for the business in general – specifically, Item 101(c)(1)(xii), which currently requires disclosure of the material effects of compliance with environmental regulations, and Item 101(c)(1)(xiii), which currently requires disclosure of the number of persons employed by the registrant.
- ***Amended rule requirements***. As amended, Item 101(c) condenses the previous 10 disclosure topics into five shorter, less prescriptive topics that largely cover the same ground.[2] The amended Item also requires discussion of information not specifically

[1] Amended Item 101(a) retains the following topics that a company may need to address, if material: (i) any bankruptcy proceeding, (ii) the effects of any material merger and (iii) the acquisition or disposition of a material amount of assets not in the ordinary course of business. Amended Item 101(a) adds a new topic that may require disclosure (if material to a general understanding of the development of the business), regarding material changes to a company's business strategy, but only if such strategy was previously disclosed.

[2] Amended Item 101(c) retains, with some changes, the following disclosure topics: (i) principal products produced and services rendered, and dependence on certain customers, (ii) new products and competitive conditions, (iii) sources and availability of raw materials and intellectual property, (iv) business subject to renegotiation or termination of government contracts and (v) seasonality of the business. Amended Item 101(c) deletes references to: (i) disclosure about new segments, (ii) dollar amount of backlog orders and (iii) working capital practices, as these topics are generally discussed in MD&A if material.

addressed by the five disclosure topics, if such information would be material to an understanding of the business. The amendments also expand the two items in 101(c) that are required to be disclosed for the business as a whole to the extent material to understanding the business.

- As amended, this Item requires disclosure of the impact of compliance with any government regulations on a company's capital expenditures, earnings, and competitive position, including, but not limited to, environmental regulations. The amended Item also requires companies to disclose material estimated capital expenditures for environmental control facilities for the current fiscal year and any other material subsequent period.
- The amended Item now also requires a description of the company's human capital resources, including any measures or objectives that the company focuses on in managing its business, such as those that address development, attraction, and retention of personnel.

Commentary: Evolving Human Capital and Sustainability Disclosure

- Human Capital. The adopting release expressly declined to define "human capital" as added to Item 101(c), reasoning that it could vary by industry and evolve over time.
  - At the SEC's open meeting to adopt the final rules, Commissioners Allison Herren Lee and Caroline A. Crenshaw expressed concern regarding the final rule's lack of direct mention of diversity disclosures. Chairman Jay Clayton and Division of Corporation Finance Director Bill Hinman pointed to existing Staff guidance on this topic, Regulation S-K Compliance and Disclosure Interpretations 116.11 & 113.13, which discuss the Staff's diversity disclosure views in the context of Regulation S-K Items 401 and 407.
  - Without prescribed disclosures relating to human capital and in light of the wide variety of disclosures companies have adopted prior to this change to Item 101(c), we expect that industries will develop different practices over time, including in response to investor focus.
- Sustainability. The SEC published an interpretive release in 2010 that provided guidance on the SEC's disclosure requirements as applied to climate change matters. However, other than as described above, the revisions to Item 101(c) do not include new requirements regarding environmental and sustainability disclosures. In their statements, both Commissioners Lee and Crenshaw decried the lack of amendments relating to climate risk disclosure.
  - Environmental and sustainability disclosures remain important for many investors and companies. Covington's Sustainability Solutions Toolkit can provide public companies with an entry point for analysis, understanding and tailored advice on this wide-ranging topic.

3 Item 103 — Legal Proceedings

While the amendments to Item 103 are not likely to significantly curtail the scope of the existing disclosure requirements for most public companies, they do provide additional flexibility generally, through the use of internal hyperlinks, and for specific legal proceedings as discussed below.

- ***Current rule requirements***. Item 103 requires the disclosure of material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the company or any of its subsidiaries is a party or of which any of their property is the subject. Instruction 5.C.[3] to Item 103 requires companies to disclose any proceeding under environmental laws to which a governmental authority is a party, unless the company reasonably believes the proceeding will not result in sanctions of $100,000 or more.
- ***Amended rule requirements***. The core of Item 103's disclosure requirements remain largely unchanged save for two amendments.
  - Internal hyperlink or cross-reference. As amended, Item 103 permits companies to satisfy Item 103 disclosure requirements by means of an internal hyperlink, or cross-reference, to legal proceedings disclosures that meet Item 103's requirements elsewhere in the document, such as in MD&A, risk factors, or in the notes to the financial statements (e.g., a note discussing material contingencies). This amendment effectively codifies a practice that many public companies follow as a practical way to avoid duplicative disclosures in the same document.
  - Environmental law proceedings. Under amended Item 103, a company will not be required to disclose environmental proceedings where the government is a party if the company reasonably believes that potential monetary sanctions will be (a) less than $300,000 or (b) less than a threshold amount chosen by the company. A company can base its disclosures upon a threshold amount it has set so long as (i) the company determines its threshold amount is reasonably designed to result in disclosure of any such proceeding that is material to the business or its financial condition; (ii) the threshold amount, and any changes to that amount, are disclosed in each annual and quarterly report; and (iii) the threshold amount does not exceed the lesser of $1 million or one percent of the company's current consolidated assets.

4 Item 105 — Risk Factors

The SEC has amended Item 105 in an effort to encourage the disclosure of fewer, more tailored risk factors and to improve the readability of the risk factor presentation overall.

- ***Current rule requirements***. Item 105 requires a concise and logically organized discussion of the most significant factors that make an investment in the public company or offering speculative or risky.

[3] The final rule also reorganized Item 103 to eliminate the current instructions to the item and incorporate their contents into the text of Item 103.

- ***Amended rule requirements***. As amended, Item 105 includes a new requirement to include a risk factor summary in certain circumstances, changes the threshold standard for disclosure, and mandates the use of a separate "General Risk Factor" section.
  - Risk factor summary. If a company's risk factor disclosure exceeds 15 pages, new Item 105(b) will require a summary of the risk factor disclosure, which may not exceed two pages and which should take the form of a series of concise, bulleted or numbered statements summarizing the principal factors that make an investment in the company or offering speculative or risky. This two page risk factor summary is required to be presented in the forepart of the registration statement, annual report, or other filing in which it is included.
  - Presentation of material risks. Under amended Item 105, companies will be required to disclose the material factors that make an investment in the company or offering speculative or risky. This represents a change from existing Item 105, which calls for disclosure of the "most significant" risks.
  - Risk factor headings. Amended Item 105 discourages disclosure of risks that could apply generally to any company or offering, but if such risks are included, they must appear at the end of the risk factor section under the caption "General Risk Factors."[4] Amended Item 105 also requires companies to organize their risk factor disclosure under relevant headings, in addition to the descriptive subcaptions that are currently required. Many companies already organize their risk factor disclosure through groupings of related risk factors and the use of headings.

Commentary: Reduced Number of Risk Factors?

- The operation of the 15-page threshold that triggers a two-page summary is designed to elicit material and concise risk factor disclosure and encourage companies to reduce the length of such discussion. The SEC acknowledged that this incentive will be weighed by companies against perceived litigation risks that could result from omissions in streamlined risk factor presentations.

5 Effectiveness and Additional Regulation S-K Rulemaking

- The amendments to these Items will be effective 30 days after the date of publication in the Federal Register, and are accordingly likely to apply to companies' periodic reports for the period ending September 30, 2020.

[4] The SEC noted in the final rule that the new General Risk Factors heading requirement does not limit the ability of a company to include appropriate cautionary language with respect to any forward-looking statements. Some commentators had expressed concern that the inclusion of a risk factor under the General Risk Factors heading would not satisfy the "meaningful cautionary language" requirement of the Private Securities Litigation Reform Act (PSLRA) safe harbor for forward-looking statements. In response to these concerns, the SEC noted that if a company includes one or more risk factors under the "General Risk Factors" caption, that fact alone should not affect the availability of the PSLRA safe harbor.

- The SEC also proposed amendments in February 2020 to modernize and simplify other disclosure requirements in Regulation S-K including selected financial data (Item 301), supplementary financial information (Item 303), and MD&A. Final rulemaking for that proposal is listed in the SEC's short-term regulatory agenda for consideration in the spring of 2021.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Securities and Capital Markets practice:

Kerry Burke	+1 202 662 5859	kburke@cov.com
Christopher DeCresce	+1 212 841 1017	cdecresce@cov.com
David Engvall	+1 202 662 5307	dengvall@cov.com
Andy Jack	+1 202 662 5232	ajack@cov.com
Brian Rosenzweig	+1 212 841 1108	brosenzweig@cov.com
David Martin	+1 202 662 5128	dmartin@cov.com
Matt Franker	+1 202 662 5895	mfranker@cov.com
Reid Hooper	+1 202 662 5984	rhooper@cov.com
Anna Rice Abramson	+1 202 662 5923	aabramson@cov.com
Sebastian Marotta	+1 202 662 5724	smarotta@cov.com
Will Mastrianna*	+1 202 662 5217	wmastrianna@cov.com

*Member of the Bar of New York. District of Columbia bar application pending; supervised by principals of the firm.

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.