

September 1, 2020

SEC Amends Disclosure Requirements for Business Sections, Legal Proceedings and Risk Factors

On August 26, 2020, the SEC adopted amendments to Regulation S-K that update disclosure requirements in Item 101(a) (description of the general development of the business), Item 101(c) (narrative description of the business), Item 103 (legal proceedings) and Item 105 (risk factors). The SEC believes the changes will result in a more principles-based, registrant-specific and cost efficient approach to disclosure that will facilitate an understanding of the performance of a registrant's business, its financial position and prospects through the eyes of its management and board of directors.

Since Regulation S-K does not apply to foreign private issuers unless a form reserved for foreign private issuers (e.g., Form F-1, F-3 or F-4) specifically refers to Regulation S-K, the amendments to Items 101 and 103 apply only to domestic registrants and foreign private issuers that have elected to file on domestic forms. The amendments to Item 105 apply to both domestic and foreign private issuers.

The amendments become effective 30 days after the date of the publication of the adopting release ("Adopting Release") (available [here](#)) in the *Federal Register*.

Summary of Amendments

Item 101(a) – General Development of Business

Item 101(a) requires a registrant to describe the general development of its business during the past five years (or such shorter time period the registrant has been in existence) based on a set of specific items.

The amendments eliminate the five-year disclosure timeframe. Disclosure is to focus on information material to an understanding of the development of a registrant's business, irrespective of a specific timeframe.

The amendments also eliminate the prescriptive list of disclosure items and provide instead a non-exclusive list of the types of information that may need to be disclosed to the extent that such information is material to an understanding of the general development of the registrant's business. The information to be provided largely matches the disclosure items in the current prescriptive list, with one new item requiring disclosure of any material changes to a previously disclosed business strategy. While there is no requirement to disclose a registrant's business strategy, if a registrant does provide the disclosure, then it will be required to disclose changes thereto, to the extent material to an understanding of the development of the business. Note that the SEC declined to provide a definition of business strategy, and it also declined to provide a safe

harbor to address concerns over disclosure of competitive or sensitive forward-looking information (in light of the fact that the principles-based approach should allow flexibility to avoid competitive or sensitive information).

The amended rules no longer require the disclosure of the year in which the registrant was organized and its form of organization, or disclosure of any material changes in the mode of conducting the registrant's business.

For filings made after a registrant's initial registration statement, registrants are now permitted to provide only an update (instead of a full discussion) of their general business development limited to material developments that have occurred since the most recent full discussion of the general developments of the business contained in a previously filed registration statement or report. Along with the update of material developments (if any), the registrant will be required to incorporate by reference (via an active hyperlink), from a single previously filed document, the most recent full discussion of the general development of the registrant's business (in its entirety). Alternatively, a registrant can provide, in each subsequent filing, a full discussion of its business development, along with any material updates. Note that the incorporation by reference feature is more restrictive than the general incorporation by reference regime, which permits incorporation from multiple previously filed documents.

Corresponding amendments are made to Item 101(h) to permit smaller reporting companies to update their business development descriptions in accordance with the new requirements set out in Item 101(a) and to eliminate the three-year look-back that applied to smaller reporting companies.

Item 101(c) – Narrative Description of Business

Item 101(c) requires a narrative description of the registrant's dominant business segment or each reportable segment about which financial information is presented in the financial statements. Under the current provision, a registrant's narrative description of any segment must cover the following items to the extent material to understanding the registrant's business: principal products produced and services rendered; new products or segments; sources and availability of raw materials; intellectual property; seasonality of the business; working capital practices; dependence on certain customers; dollar amount of backlog orders believed to be firm; business subject to renegotiation or termination of government contracts; and competitive conditions. Additionally, information relating to the material effects of compliance with environmental laws and the number of employees is required to be disclosed with regard to the registrant's business as a whole.

The amendments replace the current list of specific items with a non-exclusive list of topics to facilitate the application of the principles-based approach. A registrant's description of each reportable business segment should cover the first five items listed below, to the extent they are material to an understanding of the registrant's business. Information on compliance with government regulations and on human capital

should be included in the registrant's description of its business as a whole (unless the information is also material to a particular segment, in which case the segment should be identified), to the extent material to the registrant's business. Working capital, backlog and new segments are no longer covered. Working capital would, however, typically still be addressed in the MD&A.

The new non-exclusive topics are:

- revenue-generating activities, products and/or services, and any dependence on 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, including sources and availability of raw materials, and the duration and effect of all patents, trademarks, licenses, franchises and concessions held;
- any material portion of the business that may be subject to renegotiation of profits or termination of contracts or subcontracts at the election of a government;
- the extent to which the business is or may be seasonal (a corresponding amendment was made to the MD&A to eliminate duplicative disclosure);
- the material effects that compliance with government regulations, including environmental regulations, may have on the registrant's capital expenditures, earnings and competitive position (this disclosure is broader than what would be covered in the MD&A, as the MD&A would focus only on the impact of regulation on financial results, liquidity and capital resources); a recitation of every regulation that affects the business or operations is not required; and
- human capital, including the number of persons employed and any human capital measures or objectives ("such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel") that the registrant focuses on in managing the business.

The SEC notes that, in many cases, human capital disclosure will be important information for investors, as human capital is likely to be a material resource, a focus of management in varying ways and an important driver of performance. The references to measures and objectives that address the development, attraction and retention of personal (as non-exclusive examples of subjects that may be material) are just examples, and not mandates, as disclosure will need to be tailored to a registrant's business, workforce, and facts and circumstances. Because exact measures and objectives may evolve over time and may depend, and vary significantly, based on industry, regions or jurisdictions in which a registrant operates, as well as the

“strategic posture” of the registrant and macroeconomic and other conditions that affect human capital resources, the SEC did not include more prescriptive requirements.

Item 103 – Legal Proceedings

Item 103 requires a registrant to disclose any material pending legal proceedings, other than ordinary routine litigation, to which the registrant or any of its subsidiaries is a party or to which its property is the subject. The disclosure should include the information on the court or agency in which the proceedings are pending, the date instituted, and the principal parties thereto as well as a description of the factual basis alleged and the relief sought. A registrant must also disclose any environmental legal proceeding to which a governmental authority is a party, unless the registrant reasonably believes it will result in sanctions of less than \$100,000.

Since the information required under Item 103 often is already available elsewhere in the filing, the amendments permit registrants to provide some or all of the required information by using cross-references to disclosure found in other sections of the document, such as in MD&A, risk factors or notes to financial statements. Registrants are allowed to use multiple hyperlinks within a report.

The amendments require disclosure of any environmental proceeding that involves potential monetary sanction of \$300,000 or more (increased from \$100,000) or, at the election of the registrant, such other amount that the registrant determines is reasonably designed to result in disclosure of any such proceeding that is material to its business or financial condition. However, any proceeding where potential monetary sanctions exceed the lesser of \$1 million or one percent of the current assets of the registrant and its subsidiaries, on a consolidated basis, will need to be disclosed. If a registrant chooses to use a threshold other than \$300,000, it will be required to disclose that threshold in each annual and quarterly report.

Item 105 – Risk Factors

Item 105 requires a registrant to disclose the “most significant” factors that make an investment in the registrant or the offering speculative or risky. Risk factors must be organized logically and their disclosure must be concise. Registrants should explain how each risk factor affects the registrant or the securities being offered, should not include generic risk factors that could apply to any company or offering and should present each risk factor under a sub-caption adequately describing the risk.

The amendments to Item 105 provide for the following:

- If the risk factor section exceeds 15 pages, the registrant is required to provide summary risk factor disclosure. The summary should be a maximum of two pages and be presented in the forepart of the document as a series of concise, bulleted or numbered statements summarizing the principal factors that make an investment in the registrant or the offering speculative or risky. Since the summary is not

required to include all the risk factors included in the full risk factor discussion, registrants will be able to prioritize certain risks and omit others.

- The disclosure standard is changed from the “most significant” risk factors to the “material” risk factors that make an investment in the registrant or the offering speculative or risky. The SEC believes this change will result in registrants focusing on disclosure of only those risks to which reasonable investors attach importance in making investment or voting decisions.
- Registrants are required to organize risk factors under relevant headings in order to help investors comprehend lengthy risk disclosures by making them more user-friendly and easier to read. The amendments do not specify the risk factor headings that registrants should use.
- Generic risk factors that apply generally to other companies or offerings are to be placed at the end of the risk factor section under the caption “General Risk Factors.”

The amendments do not mandate that risks be prioritized; however, if a registrant believes that it will be useful to highlight the importance of a certain risk, the registrant is free to present that risk in a way that its relative importance becomes apparent.

What Was Not Covered

Two SEC Commissioners (Lee and Crenshaw) voted against the final amendments for failing to address diversity and climate risk and only introducing the topic of human capital without mandating certain minimal metrics (public statements, available [here](#) and [here](#)). On the subject of human capital, their principal critique was that principles-based disclosure, without at least some specifics, would not produce disclosures investors need. Similarly, they criticize the reliance on the principles-based regime as a justification for being silent on diversity and climate risk.

In his opening remarks at the meeting at which the amendments were approved (available [here](#)), Chairman Clayton dwelt at length on human capital; in fact it was the only specific item he singled out. In defense of the SEC’s principles-based approach, he noted that the human capital disclosure requirements are designed to elicit disclosure tailored to a registrant’s industry and business model, while allowing for more robust disclosure as businesses evolve. In the Adopting Release, the SEC stated that it does not believe that prescriptive requirements or a designated standard or framework will ensure more comparable disclosure given the variety in registrant operations as well as how registrants define, calculate and assess human capital measures. That being said, the SEC did state that the principles-based approach affords registrants the flexibility to tailor their disclosures to their unique circumstances, including by providing disclosure in accordance with some or all of the components of any current or future standard or framework that facilitates human capital resource disclosure that is material to an understanding of the registrant’s business taken as a whole.

On the subject of ESG more broadly, Commissioner Lee called on the SEC to lead a discussion on which specific risks and impacts should be disclosed and how, so as to work through how best investors can get standardized, consistent, reliable and comparable ESG disclosures. Commissioner Crenshaw called for the formation of an internal task force to study how investors can and do use information about human capital management, climate change risk and other ESG metrics to assess long-term financial performance. She also called for formation of an external ESG Advisory Committee, comprised of investors, issuers and subject matter experts, to provide advice and guidance on ESG trends.

In light of the significant focus on ESG topics in the markets generally, it is unlikely that these amendments will be the last word on ESG disclosures.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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