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SEC proposes to amend requirements for disclosure on business, legal proceedings and risk factors

On August 8, the SEC proposed amendments to Regulation S-K to modernize required disclosures on business, legal proceedings and risk factors in Exchange Act and Securities Act filings. The proposed amendments represent the latest phase of the SEC's disclosure effectiveness initiative. Unlike other recent rule changes, the proposed amendments would reshape several of the SEC's fundamental disclosure requirements.

Comments on the proposed amendments are due by October 22. The number of specific requests for comments solicited by the SEC suggests that the final amendments might differ from the rule proposal in important respects.

The SEC's release describing the proposed amendments can be found [here](#).

Regulatory considerations

Three noteworthy considerations underpin the SEC's approach to this latest round of proposed disclosure changes.

Principles-based versus prescriptive disclosure requirements. The SEC proposes to shift some of the disclosure requirements from a "prescriptive" approach to a more "principles-based" approach. Principles-based rules require a company's management to evaluate the significance of information in the context of the company's overall business and financial circumstances and to determine whether disclosure is necessary. Prescriptive disclosure requirements, on the other hand, use bright-line, quantitative or other thresholds to determine whether disclosure is required, or simply direct all companies to disclose the same type of information. The SEC observes that while prescriptive disclosure requirements can enhance comparability and consistency, principles-based disclosure may enable a company to provide investors with more tailored disclosure and reduce disclosure that is irrelevant, outdated or immaterial.

The SEC is proposing to revise some elements of the business and risk factor disclosure requirements to emphasize a principles-based approach because, the SEC says, "the current disclosure requirements may not reflect what is material to every business," and prescriptive disclosure requirements "can become outdated in these areas." The SEC proposes to retain a more prescriptive approach to disclosure of legal proceedings since, in its view, "that requirement depends less on the specific characteristics of individual registrants."

Use of hyperlinks. The proposed amendments reflect the SEC's continuing efforts to increase the use of hyperlinks in order to reduce redundant disclosures in filings, better integrate disclosures within and across filings, and facilitate investor access to prior disclosures. In rule amendments that became effective in 2017 the SEC required companies to include an active hyperlink to each exhibit included in a filing's exhibit index, so that users can view the exhibit by simply clicking on the exhibit name. This year the SEC revised rules under the Securities Act and the Exchange Act to require registrants to include an active hyperlink to information incorporated by reference into a registration statement or report if the information is publicly available on EDGAR. As discussed below, the SEC now is proposing to expand the use of hyperlinks in disclosures regarding business and legal proceedings.

Tailoring of changes to different registrant categories. The proposed rule changes would incorporate varying disclosure requirements based on a registrant's classification. For example, the SEC proposes not to extend certain principles-based business disclosure requirements to smaller reporting companies, believing that more prescriptive disclosure standards regarding business development, description of business and other specified information for this registrant class is consistent with the scaled disclosure requirements generally applicable to these companies. In addition, the proposed amendments to business and legal proceedings disclosures would apply to foreign private issuers only if they have elected to file on domestic forms, while the proposed amendments to risk factor disclosure would apply to all foreign private issuers.

Summary of proposed amendments

The rule amendments would affect Regulation S-K Items 101 (Description of Business), 103 (Legal Proceedings) and 105 (Risk Factors).

Description of business (Items 101(a) and 101(c)). Item 101(a) of Regulation S-K currently requires the company to describe the general development of its business during the past five years or any shorter period in which the company has been engaged in business. The rule requires disclosure of specified categories of information, including, among others, material changes in the mode of conducting business and the nature of any material merger or consolidation. Item 101(c) requires the company to provide a narrative description of its business, and enumerates 12 items the company must discuss generally, if material to an understanding of its business.

If approved in the form proposed, the amendments to Items 101(a) and 101(c) would include the following changes to business disclosure:

- **Elimination of five-year look-back:** Eliminate the prescribed five-year period for the description of the development of the business and permit companies instead to provide information material to an understanding of these matters regardless of the period covered. This change reflects the SEC's view that the time-period requirement does not adequately account for the diverse histories of SEC-reporting companies, which range from start-ups to well-established companies with many decades of reporting history.
- **Updating of prior disclosure and use of hyperlinking:** Permit a company, in filings made after its initial registration statement, to provide only an update to the description of the development of the business that would focus on material changes, if any, during the reporting period, accompanied by a hyperlink to the company's most recent prior filing which, together with the update, would contain the full discussion of the general development of the company's business.
- **Use of principles-based approach:** Make the disclosure of the development of the business more principles-based by providing a non-exclusive list of four topics a company may need to disclose under Item 101(a), and by requiring the disclosure only to the extent material to an understanding of the general development of the company's business. In addition to the new disclosure topic concerning changes to business strategy, as discussed below, the non-exclusive list of disclosure topics would continue to include information about (1) material bankruptcy proceedings, (2) the nature and effects of any material merger and (3) the acquisition or disposition of any material amount of assets.
- **Disclosure of changes to business strategy:** Add to the list of business development disclosure topics a requirement to discuss transactions and events that affect or may affect the company's operations, including material changes to any previously disclosed business strategy, to the extent that the information is material to an understanding of the company's business. In this regard, the SEC emphasizes that because the business strategy of some companies may be competitively sensitive, the amended rule would not require companies to add a discussion of material changes to their business strategy if they have not discussed their strategy in prior filings.
- **Revision to list of narrative topics:** Revise the current list of 12 disclosure topics specified for the narrative description of the business to eliminate some topics (including disclosure about new segments, backlog and working capital practices) and to add or refocus other topics (including disclosure on regulatory compliance

and human capital resources, as discussed below). The proposed topics would not be line-item requirements, but rather in each case would need to be discussed only to the extent material to an understanding of the company's business taken as a whole.

- *Expansion of regulatory compliance disclosure:* Modify the regulatory compliance disclosure required in the narrative description of the business to address not only compliance with environmental laws, as under the current rule, but also the material effects of compliance with other material government regulations, both foreign and domestic. In proposing this change, the SEC notes that although not currently required by Item 101(c), many companies already discuss other relevant government regulations relevant to their business.
- *Addition of new disclosure on human capital resources:* Replace the current requirement to disclose the number of employees with a new requirement to describe the company's human capital resources, in recognition of the fact that in today's economy a requirement to disclose the number of employees no longer may be an effective means to elicit the information most relevant to an investment decision. The new disclosure would include 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 employees, contractors or other human capital), to the extent material to an understanding of the company's business.

The proposed amendments would eliminate the current requirement in Item 101(h) that smaller reporting companies describe the general development of the business over the preceding three years, while retaining the requirement that if a smaller reporting company has not been in business for three years, it must provide the same information for its predecessors if there are any. The proposed amendments also would retain the more prescriptive disclosure requirements currently applicable to other elements of the business description for smaller reporting companies.

Legal proceedings (Item 103). Item 103 currently requires a company to disclose any 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 their property is subject. The company must disclose the name of the court, the date the proceeding was instituted, the principal parties, and the underlying facts alleged and relief sought. An instruction to the current rule further requires the company to disclose any proceedings under environmental laws to which the government is a party unless the company reasonably believes that monetary sanctions resulting from the proceeding will be less than \$100,000.

If approved in the form proposed, the amendments to Item 103 would include the following changes to legal proceedings disclosure:

- *Use of hyperlink to other disclosure in the filing:* Expressly permit disclosure regarding material legal proceedings to be provided by including hyperlinks or cross-references to legal proceedings information located elsewhere in the filing (such as disclosure in the contingencies footnote of the financial statements).
- *Increase of disclosure threshold for environmental proceedings:* Increase the disclosure threshold for environmental proceedings to which the government is a party from \$100,000 to \$300,000, to account for inflation since the adoption of this requirement in 1982. In determining to retain a specified disclosure threshold based on the imposition of a governmental fine, the SEC took into account that such a threshold may be important to investors in assessing a company's environmental compliance, may provide a useful benchmark for companies when determining whether to disclose a particular proceeding, and may promote comparability in disclosure among registrants.

Risk factors (Item 105). Item 105 currently requires the company to disclose the "most significant" factors that make an investment in the company or offering speculative or risky and directs the company to describe how each risk affects the company or the offered securities. The SEC notes that risk factor disclosures have tended to become longer over time and to include "boilerplate" risks that are not specifically tailored to the individual business. For years, the SEC staff has tried to discourage companies from being over-inclusive in disclosing risks in their efforts to

mitigate potential liability. The proposed amendments reflect another attempt to counteract this practice without resorting to a page limit for the risk factor disclosure, as the SEC previously has considered.

If approved in the form proposed, the amendments to Item 105 would include the following changes to risk factor disclosure:

- *Addition of summary:* If the risk factor disclosure exceeds 15 pages, require companies to include summary risk factor disclosure, consisting of a concise, bulleted or numbered list which highlights the principal risks, to be located in the forepart of the report or prospectus under an appropriately captioned heading. The SEC estimates that the 15-page threshold would affect approximately 40% of current filers.
- *Use of materiality standard:* Replace the requirement to disclose the “most significant” risk factors with a requirement to disclose “material” risk factors, to encourage management to disclose the risks which it believes reasonable investors would consider important in making an investment decision.
- *Organization by risk type:* Require risk factors to be organized under relevant headings, as many companies already organize them, and require any risk factors generally applicable to any company or offering to be disclosed (if at all) at the end of the risk factor disclosure under a separate heading captioned “General Risk Factors.”

Conclusion

Registrants should welcome the SEC’s efforts to permit them to reduce disclosure about matters they do not consider material. The proposed amendments would offer companies flexibility to tailor their disclosure to fit their business, and should allow more streamlined and less repetitive presentations.

At the same time, the proposed shift to a principles-based approach to disclosure about the company’s business and risks is likely to encounter some opposition, particularly from investor advocates, who often challenge rule changes that might reduce the amount of information companies are required to disclose. In the cost-benefit analysis section of its release, the SEC acknowledges that “shifting to a more principles-based approach may result in the elimination of disclosure material to an investment decision if issuers misjudge what information is material.” The SEC has included in its rule proposal several requests for comment that solicit views on whether the agency should shift to a more principles-based approach and whether the proposed principles-based requirements would elicit information that is material to an investment decision. The comment period may prove to be especially lively as commenters debate the appropriateness of this feature and other aspects of the proposed amendments.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the following page of this update.

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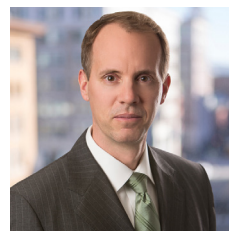
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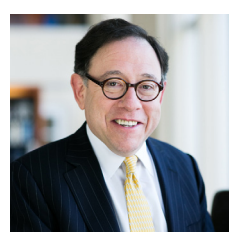
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