

The SEC's Latest Disclosure Simplification Proposal

August 15, 2019

Last week, the Securities and Exchange Commission issued another in its series of rule proposals to revise the disclosure requirements applicable to reporting companies. Its August 8, 2019 proposal addresses simplification of three items in Regulation S-K that have not been revised for more than 30 years:

- the description of the registrant's business (Item 101),
- legal proceedings (Item 103) and
- risk factors (Item 105).

The most recent proposal is one of several that follow up on an [April 2016 SEC concept release](#) asking about the value to investors of the disclosures registrants provide under the SEC's rules. Many commenters on the April 2016 release urged the Commission to consider eliminating prescriptive requirements in favor of a principles-based regime focused on information that is material to investors.

The new proposal appears to move towards a principles-based approach to business and risk factor disclosure, while maintaining a more prescriptive format for disclosure of legal proceedings.

Introducing Cleary's Disclosure Simplification Explainer

Since the JOBS Act in 2012, the SEC has undertaken a number of initiatives that aim (1) to allow companies to stay private longer, (2) to make it easier for companies to go public and (3) to ease and update disclosure requirements for public companies.

The different disclosure simplification projects can be difficult to sort out. To help follow the different workstreams, we have prepared a chart we call the Disclosure Simplification Explainer, which maps them and provides live links to each of the underlying SEC releases.

Here is a [link](#) to the Explainer. We will keep it updated as the SEC takes additional steps in its simplification campaign.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

New York
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

Nicolas Grabar
+1 212 225 2414
ngrabar@cgsh.com

Andrea M. Basham
+1 212 225 2755
abasham@cgsh.com



General Development of a Registrant's Business

Item 101(a) of Regulation S-K currently requires a description of the development of a registrant's business that covers five enumerated items and goes back five years. The proposal would change the disclosure requirement to be based exclusively on a materiality determination and would make the following specific changes, each of which we believe would encourage more streamlined disclosure.

- The five-year timeframe would be eliminated.
- The proposal includes a non-exclusive list of four types of information a registrant should consider disclosing, if material. Three of these are enumerated in the existing rule (bankruptcy/receivership, material reorganizations and material acquisitions/dispositions). One is new — disclosure of material changes to a previously disclosed business strategy.
- A registrant would be permitted to update this information after its initial filing, with a hyperlink to its original filing containing the broader business development description. It's unclear exactly how this would work in the case of multiple updates – we expect that commenters will suggest practical solutions.

Narrative Description of a Registrant's Business

Item 101(c) of Regulation S-K currently requires a narrative description of a registrant's business based on 12 enumerated items. Although the 12 items are only required to be described if material, the release acknowledges that many registrants may interpret Item 101(c) as requiring disclosure of all of the items, even if not material. The revised rule would require only a description of material elements of a registrant's business. A non-exclusive list of information a registrant should consider disclosing would still be included, with seven broad categories. These include, notably, human capital disclosure (a topic not previously required by any rule), which includes recruitment, employment and hiring practices, benefit

and grievance mechanisms, employee training and engagement, workplace health and safety, human capital management strategies and related legal proceedings, collective bargaining arrangements and employee compensation and incentive programs.

Legal Proceedings

The proposal would leave Item 103 of Regulation S-K (legal proceedings) largely intact, on the grounds that a prescriptive approach is more appropriate for this topic, where a particular registrant's unique circumstances are less relevant to an investor than the likelihood of any legal proceeding having a material impact on the registrant. The proposal would streamline this disclosure in two ways:

- Required information could be provided by including hyperlinks or cross-references to disclosure located elsewhere in the document (e.g., MD&A or the contingencies footnote in the financial statements). Registrants may prefer not to move forward-looking and other information to the financial statements footnote, however, among other reasons because the PSLRA safe harbor for forward-looking statements does not cover the financial statements.
- The \$100,000 threshold for disclosure of environmental proceedings to which the government is a party would be raised to \$300,000 to adjust for inflation.

Risk Factors

Some of the proposed changes in Item 105 (risk factor disclosure) may not make much difference in registrants' disclosure – one change would require disclosure of "material" factors instead of "the most significant" factors, and another would require risk factors to be organized under relevant headings. Most registrants already follow those approaches. The proposed rules would also require summary risk factor disclosure if the risk factor section exceeds 15 pages, which the proposal estimates will affect 40% of registrants.

Looking Ahead

Beyond the particulars, the recent collection of proposals suggest three questions of broader interest:

— Will Disclosure Requirements Finally Become Principles-Based?

SEC Chair Jay Clayton and Corporation Finance chief Bill Hinman have said on several occasions that corporate disclosures would be more useful and effective if they were driven by principles and materiality judgments rather than following prescriptive rules. In this respect, the new proposals go beyond previous episodes in the disclosure simplification campaign. A real test of this orientation will be the proposal on MD&A (Item 303 of Regulation S-K) that is included in the SEC's regulatory short-term agenda but has not yet seen the light of day.

— Is Disclosure Simplification Even Possible?

The SEC can simplify its rules, but the complexity and density of corporate disclosures are not just a product of rules. It reflects, in part, the very widely-held attitude that making disclosures longer and more complicated has no incremental cost and may have some benefits in managing risks – concerning civil liability, enforcement activity and other regulatory entanglements of the company, its management and gatekeepers (especially auditors and audit committees). To take the example of risk factors, there is reason to doubt that the SEC's proposal will result in shorter or more focused disclosure.

— What About Foreign Private Issuers?

In the SEC's disclosure system, FPIs are subject to a different set of rules from domestic issuers, mostly contained in Form 20-F. The proposals do not address Form 20-F, so they will not directly affect FPIs (except for the risk factor requirements in Securities Act registration statements, which are subject to Item 105 of Regulation S-K even for FPIs). It is hard to see why the SEC should not make similar changes to Form 20-F. Form 20-F is derived from a form promulgated back in 1998 by

IOSCO (the International Organization of Securities Commissions), which closely followed then-applicable SEC rules. It would be an oversight for the SEC to now modernize its rules for domestic issuers and leave Form 20-F untouched. The expected proposal on MD&A will present a similar issue, with possibly more at stake.

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