

SEC Proposes Major Changes to MD&A and Related Requirements

January 31, 2020

Yesterday the Securities and Exchange Commission proposed amendments to Regulation S-K, including changes to its MD&A requirements that would, if adopted, make significant and long-overdue improvements to a central disclosure requirement of the U.S. securities laws.

The twin themes of the proposals are dropping outmoded requirements and taking a more principles-based approach. This memorandum provides a brief summary of the proposals, and we will follow up with more analysis as we digest the details.

The full text of the proposals is available [here](#).

In separate action on a related topic, the SEC issued guidance about the presentation of performance metrics in MD&A; our alert on the guidance is available [here](#). Also, prompted by the MD&A proposals, SEC Chair Clayton and Commissioners Lee and Peirce each issued statements on climate-related disclosures in SEC filings.

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Background and context

The proposals are based in large part on the SEC staff's November 2016 Report on Modernization and Simplification of Regulation S-K, as well as a July 2016 concept release on the business and financial disclosure requirements in Regulation S-K. They are part of a broader "disclosure effectiveness initiative" (DEI) undertaken by the SEC and its staff, partly at the direction of Congress. The stated objective of the DEI is to improve the SEC disclosure regime for both investors and companies. See Cleary Gottlieb's Disclosure Simplification Explainer [here](#).

Some of the prior rulemaking in the DEI has been fairly technical, and these proposals are the most ambitious yet. They address MD&A, which is one of the core disclosure requirements under the SEC's forms, and they include some major changes. The general orientation of the proposals – dropping requirements that have become obsolete, replacing prescriptive rules with principles-based requirements, and clarifying requirements that have not previously been properly codified – is sensible, and our preliminary reaction is that the changes will be welcomed by registrants and may not provoke major opposition. Commissioner Lee issued a statement saying she does not support the proposal, because it does not address climate-change disclosures; she also expressed concern with the increased flexibility that the principles-based approach gives investors, and invited public comment on these issues.

Major elements of the proposals

The elements of the proposals that appear on first reading to be the most significant are summarized below. Although not specifically described here, the proposals include parallel amendments applicable to disclosures provided by foreign private issuers.

Items 301 and 302(a) of Regulation S-K

- ***Elimination of Item 301 (Selected Financial Data)***. The proposal would completely eliminate Item 301 of Regulation S-K, which requires most companies to furnish selected financial data in comparative tabular form for each of the

company's last five fiscal years (or for the life of the company, if less).

The SEC acknowledged that the availability of a company's prior filings on EDGAR and the tagging of financial information using eXtensible Business Reporting Language (XBRL) has facilitated the access to information in a way that was not possible when the precursor to Item 301 was adopted in 1970. The original purpose of Item 301 – to provide trend disclosure – is now served by Item 303 (MD&A), which specifically calls for disclosure of material trend information. The proposal notes that companies may continue to include a tabular presentation of financial information to the extent that such presentation would be useful for understanding MD&A disclosure.

- ***Elimination of Item 302(a) (Supplementary Financial Information)***. The proposal would eliminate Item 302(a) of Regulation S-K, which requires disclosure of selected financial data for each quarter within the two most recent fiscal years. It also requires disclosure of variances in the results from amounts previously reported on a Form 10-Q, and a description of the effect of any discontinued operations and unusual or infrequently occurring items.

The SEC believes that eliminating Item 302(a) would encourage companies to adopt a more principles-based approach to presenting quarterly information. Most of the data required by Item 302(a) can already be found in prior quarterly reports available on EDGAR, except for certain fourth quarter information, which can be calculated from a company's annual report and third quarter 10-Q.

As with Item 301, the original purposes of Item 302(a) are currently satisfied by other existing requirements, including MD&A (requiring a discussion of unusual events that materially affect reported income and trends and uncertainties that have an impact on net sales, revenues, or operating income), and U.S. GAAP disclosure rules

(requiring disclosure of disposals of components of an entity and unusual or infrequently occurring items for the fourth quarter).

Item 303 of Regulation S-K (MD&A)

- **Elimination of Item 303(a)(5) (Contractual Obligations Table) and Enhancement of Item 303(a)(2) (Capital Resources).** The proposal would eliminate the contractual obligations table of Item 303(a)(5). The SEC believes that eliminating the requirement would not result in a loss of material information to investors given the overlap with information required under accounting standards. To address the potential concern that accounting standards do not require all of the information required by Item 303(a)(5), the SEC is also proposing to amend Item 303(a)(2) to specifically require a discussion of material cash commitments of the company, including but not limited to capital expenditures.

Like many of the other proposed changes in this release, the elimination of the contractual obligations table is intended to reduce redundancy and streamline disclosure.

- **Requirement of Critical Accounting Estimates.** The proposal would explicitly require disclosure of critical accounting estimates in Item 303 of Regulation S-K, codifying longstanding SEC guidance on the subject. A critical accounting estimate would be defined as an estimate made in accordance with generally accepted accounting principles that involves a significant level of estimation uncertainty and has had or is reasonably likely to have a material impact on the company's financial condition or results of operations. To avoid duplication with the financial statement discussion of significant accounting policies, the proposal includes an instruction specifying that the disclosure of critical accounting estimates should supplement, but not duplicate, the description of accounting policies or other disclosures in the notes to the financial statements.
- **Replacement of Item 303(a)(4) (Off-balance Sheet Arrangements) with Instruction.** The

proposal would replace current Item 303(a)(4), the requirement that registrants provide disclosures about off-balance sheet arrangements in a separately captioned section, with an instruction emphasizing the importance of discussing these obligations in the broader context of MD&A disclosure when they have or are reasonably likely to have a material current or future effect on a registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources.

The proposal notes that updates made to U.S. GAAP since the implementation of Item 303(a)(4) have resulted in substantial disclosure overlap. The proposed change is intended to encourage a more principles-based approach to disclosure about off-balance sheet arrangements.

- **Amendment of Item 303(b) (Interim Periods).** Under the proposed amendment, companies would be permitted to compare their most recently completed quarter to either the corresponding quarter of the prior year or the immediately preceding quarter. If a company changes the comparison from the prior interim period comparison, the company would be required to explain the reason for the change and present both comparisons in the filing where the change is announced.

In making this proposal, the SEC recognized that not all businesses are seasonal and that a comparison to the corresponding quarter of the preceding year (as is currently required) may obscure the most material trends and may not be as meaningful as a comparison to the preceding quarter.

Other elements of the proposals

Other elements of the proposals include:

- Elimination of current Item 302(b), *Information About Oil and Gas Producing Activities*, subject to the Financial Accounting Standards Board's

amendment of U.S. GAAP to require the disclosure called for by Item 302(b).

- Addition of a new Item 303(a) to state the purposes of MD&A disclosure by incorporating a portion of the substance of instructions 1, 2 and 3 into the item, and codifying SEC guidance that states that companies should provide a narrative explanation of its financial statements that enables investors to see the company “through the eyes of management.”
- Elimination of unnecessary cross-references to industry guides in Instructions 13 and 14 of Item 303(a).
- Amendment of current Item 303(a)(3)(iii) to clarify that a company should discuss the reasons underlying *material changes* (as opposed to only *material increases*) from period to period in net sales or revenues.
- Elimination of current Item 303(a)(3)(iv), which requires companies to discuss the impact of inflation and changing prices.
- Simplification of current Item 303(b) by eliminating certain instructions and providing cross-references to similar instructions in Item 303(a).
- Elimination of current Items 303(c) and (d) as conforming changes.

Next steps

Comments on the proposals will be due 60 days after publication in the Federal Register, which will probably mean a deadline in mid-April. The Commission sometimes extends the comment deadline on major proposals, particularly if they are controversial. However, the Clayton-led Commission already has an ambitious slate of proposals out for comment – some far more controversial than this one – and commissioners may have their eyes on what can reasonably be adopted before any changes in the Commission after the upcoming presidential election.

Following adoption, there would be a transition period, and the proposing release says that would be 180 days

after effectiveness. That probably means that the earliest the proposed amendments would apply is some time in the second half of 2021.

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