Cooley

SEC Adopts Amendments to Regulation S-K to Modernize Descriptions of Business, Legal Proceedings and Risk Factors

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Much has changed in the US economy and business environment in the last 30 years, but one thing that hasn't is the Regulation S-K requirement for description of the business – until now that is. At the end of August, the SEC voted (three to two) to **adopt amendments to Regulation S-K** designed to modernize the descriptions of business, legal proceedings and risk factors. In crafting the final amendments, a component of the SEC's Disclosure Effectiveness Initiative, the SEC considered the many changes that have occurred since the adoption of these disclosure requirements 30 years ago, including changes in "the mix of businesses that participate in our public markets, changes in the way businesses operate, changes in technology (in particular technology that facilitates the provision of, and access to, information), and other changes that have occurred simply with the passage of time." The SEC also took into account comments received on the **2019 proposal** and the **2016 Concept Release** on disclosure simplification and modernization, as well as SEC staff experience in review of disclosures. The amendments largely reflect the SEC's historic "commitment to a principles-based, registrant-specific approach to disclosure" that, although "prescriptive in some respects," is primarily "rooted in materiality" and designed to provide an understanding of a company's business through the lens that management and the board apply in managing and assessing the company's performance. The amendments will become effective November 9, 2020.

Included as Appendix A is a version of the SEC's table of changes.

Background

SEC Chair Jay Clayton has previously described his **framework for disclosure rules** as "rooted in the principles of: (1) materiality; (2) comparability; (3) flexibility; (4) efficiency; and (5) responsibility." Consistent with that framework, he has observed, disclosure requirements must evolve over time to reflect changes in markets and industries. Many of the provisions of Regulation S-K originated when the most valuable assets reflected on companies' balance sheets were primarily fixed assets, such as property, plant and equipment. Now, many companies' most valuable assets are human capital, intellectual property and other intangible assets. While Clayton has continued to view the linchpins of the current disclosure framework as the right ones, the SEC must, **he has said**, recognize when the drivers of value have changed and reconsider the nature of the information to be assessed under the framework. In part, the final amendments reflect that effort.

To be sure, the approach taken is largely an incremental one. To enable each company to focus on the matters that are material to its business, the final amendments take a pronounced turn toward a more principles-based approach to the business and risk factor disclosure requirements, eliminating several of the explicit requirements, such as backlog disclosure, while maintaining a mostly prescriptive approach to legal proceedings**.** The most significant change that companies will need to thoughtfully address is the addition of "human capital" as one of the principles-based topics to be disclosed, to the extent material, as part of the business narrative, a change that Clayton has long foreshadowed. Many companies, in response to investor demand for more information about how human capital is measured and assessed, have taken the step of addressing their human capital management approach and practices as part of their annual proxy statements or have otherwise undertaken to expand their disclosures in light of the impact of the COVID-19 pandemic on the workforce and concern over profound racial inequities. Generally, however, companies have not shone a spotlight on workforce issues in their business disclosure included in the annual report beyond the narrow rule requirements. That is likely to change now.

And while there is no fundamental "re-imagining" of the disclosure system as a whole, such as the "company profile" approach that former SEC Chair Mary Jo White had floated back in 2013, there are some mild telltale signs. (If you recall, the company profile approach would have included a "filing and delivery framework based on the nature and frequency of the disclosures, including a 'core document' or 'company profile' with information that changes infrequently. Companies would then be required to update the core filings with information about securities offerings, financial statements, and significant events.") Here, with regard to descriptions of the *development* of the business, the SEC is eliminating repetition by permitting companies to simply update to reflect material developments in the reporting period and include a link to more complete prior disclosure regarding development.

In other respects, however, the final amendments merely reflect, **as Clayton expressed it**, "deferred maintenance" on the rules, eliminating prescriptive requirements that have long been outdated. While that modernization will certainly be welcome, it remains to be seen how substantially disclosure changes as a result of these amendments. To some extent, the changes simply update the rules to reflect current practices, rather than introducing new elements. For example, the final amendments expand the current requirement to discuss environmental regulation to cover all material governmental regulation, a practice that many companies currently observe. More broadly, the current rules regarding business narrative have, for many years, served as less of a drafting guidepost to elicit the core narrative about the business than as a post-drafting rules compliance checklist. Accordingly, other than with respect to human capital disclosure, we do not expect the business narrative to change in any fundamental ways.

Principles-based or prescriptive approach?

As noted above, the commissioners were divided in their views on adoption of the final amendments, with Commissioners Allison Lee and Caroline Crenshaw dissenting. And, political persuasions aside, that divergence was grounded largely on the fundamental issue of whether the rules should be mainly principles-based or incorporate some additional prescriptive elements.

Whether revisions to the disclosure rules should take a principles-based approach or a prescriptive approach was a question running through the 2016 Concept Release. Both approaches are based on the concept of "materiality" as defined in *TSC Industries, Inc. v. Northway, Inc.,* specifically, whether there is a substantial likelihood that a reasonable investor would consider the information important in decision-making and whether a reasonable investor would view the information to significantly alter the "total mix" of information available. Principles-based rules give much discretion to management: they "articulate a disclosure objective and look to management to exercise judgment in satisfying that objective." On the other hand, some requirements "prescribe" quantitative thresholds to minimize uncertainty in determining materiality and to identify when disclosure is required, leaving less to the discretion of management. While principles-based rules are necessarily imprecise, may be difficult to apply and can result in a loss of comparability among reporting entities, they can help to eliminate irrelevant information by permitting tailored responses that focus on information that is material to the particular business and are more flexible and adaptable as circumstances change. Prescriptive standards can help promote comparability, consistency and completeness of disclosure, but they can sometimes be circumvented, become stale and may not address or capture all the important information. An **earlier S-K study** conducted by the staff pursuant to the JOBS Act recommended that revisions emphasize an overarching principles-based approach while preserving the benefits of a rules-based system.

The considerable divergence of opinion among the SEC commissioners about the final amendments was less about what was required by the new rules than what wasn't. Notably, **Lee** and **Crenshaw** were dismayed at the silence of the new rules on two issues they viewed to be critical – diversity and climate risk. Not that the other commissioners were necessarily opposed to disclosure about those topics (although **some may have been**). Rather, they preferred not to include prescriptive requirements that would have specifically mandated diversity and climate risk disclosure, opting instead for a principles-based disclosure system that would elicit discussion of those items only to the extent that, in the view of the company, the information was material.

According to Clayton, the SEC's principles-based disclosure

> framework in providing the public with the information necessary to make informed investment decisions has proven its merit time and again as markets have evolved when we have faced unanticipated events. This has been widely demonstrated in registrant disclosures regarding the effects of COVID-19. We have seen disclosures shift to emphasize matters such as liquidity, cash needs, supply chain risks, and the health and safety of employees and customers. This has served as a reminder that our rigorous, principles-based, flexible disclosure system, where companies are required to communicate regularly and consistently with market participants, provides countless benefits to our markets, our investors and our economy more generally.

The SEC's disclosure framework, Clayton later remarked, is "the envy of the world." To illustrate the approach, Clayton highlighted the new principles-based focus on metrics in the area of human capital:

> In crafting their human capital disclosure, companies must incorporate the key human capital metrics, if any, that they focus on in managing the business, again to the extent material to an understanding of the company's business as a whole. Experience demonstrates that these metrics, including their construction and their use, [vary] widely from industry to industry and issuer to issuer, depending [on] a wide array of company-specific factors and strategic judgments. As I have said previously, I would expect that the material human capital information for a manufacturing company will be vastly different from that of a biotech startup, and again vastly different from that of a large healthcare provider. And the human capital considerations for a multi-national car manufacturer will be different from that of a regional home manufacturer. It would run counter to our proven disclosure system, particularly as we first increase regulatory emphasis in an area of such wide variance, for us to attempt to prescribe specific, rigid metrics that would not capture or effectively communicate these substantial differences. That said, under the principles-based approach, I do expect to see meaningful qualitative and quantitative disclosure, including, as appropriate, disclosure of metrics that companies actually use in managing their affairs.

Lee and Crenshaw, on the other hand, argued for a more balanced approach that would have included some prescriptive line-item disclosure requirements and provided more certainty in eliciting the type of disclosure that investors were seeking. According to Lee, the SEC

> received thousands of comments seeking disclosure on workforce development, diversity, and climate risk. There were letters explaining why principles-based disclosure requirements, without at least some specifics, would not produce the disclosures investors need. Letters explaining what metrics were most important in terms of building long-term value for investors. Letters explaining what metrics cut across industries and what companies were already tracking.

What's more, she added,

> Recent events have provided a real-time case study on the need for many of these disclosures. It has never been more clear that investors need information regarding, for example, how companies treat and value their workers, how they prioritize diversity in the face of profound racial injustice, and how their assets and business models are exposed to climate risk as the frequency and intensity of climate events increase. This year's upheavals have driven home that ESG risks, like those associated with diversity and climate change, are strong predictors for resilience and for maximizing risk-adjusted returns.

However, she observed, the SEC "takes the position that it does not need to require or specify these types of disclosures because our principles-based disclosure regime is on the job and will produce any disclosures on these topics that are material. Investors are asked to trust that each individual company has gauged materiality on these complex issues with flawless precision and objectivity." But, she asks, hundreds of companies don't include disclosure on diversity – should we assume that it is therefore not material? As Lee has previously **written** (with former Commissioner Robert Jackson), while issuers may "prefer the discretion afforded to them by principles-based disclosure," investors "favor a balanced approach using some line-item disclosure rules." Although a principles-based approach offers flexibility and "makes sense in some cases," the costs must be weighed against the benefits. One cost could be the level of discretion "that it gives company executives…over what they tell investors. Another is that it can produce inconsistent information that investors cannot easily compare, making investment analysis—and, thus, capital—more expensive."

The final amendments

The final amendments are summarized below:

Development of business (Item 101(a))

Currently, this item requires a description of the general development of the business during the past five years, or any shorter period the company may have been in business. The changes in the final amendments are designed to make the requirements more principles-based and more flexible.

- *Non-exclusive list of topics*. As adopted, the rule will now provide a non-exclusive list of four topics, and companies will need to include disclosure regarding any of the topics only to the extent the information would be material to an understanding of the general development of the business. The SEC believes that the approach will provide flexibility, while focusing on materiality. To the extent there is material information beyond the four topics, the company would be required to disclose that information as well. The identified topics are:

  (i) Any material changes to a previously disclosed business strategy;

  (ii) The nature and effects of any material bankruptcy, receivership, or any similar proceeding with respect to the registrant or any of its significant subsidiaries;

  (iii) The nature and effects of any material reclassification, merger or consolidation of the registrant or any of its significant subsidiaries; and

  (iv) The acquisition or disposition of any material amount of assets otherwise than in the ordinary course of business.

- *Material changes to strategy*. Material changes to strategy, the first bullet point above, is an addition to the current rule. Because many companies discuss their strategies as part of their IPO registration statements, the SEC believes that material changes to a strategy that has previously been disclosed may be material to investors, notwithstanding objections from some commenters that the rule would result in disparate treatment for those companies that had not disclosed their strategies.
- *Eliminate prescribed timeframes*. Instead of the currently required five-year timeframe (three years for smaller reporting companies), companies will need to focus on the period over which information is material. The SEC thought that the current timeframe "may not always elicit the most relevant disclosure" for every company. In some cases, a period longer than five years might be appropriate, and in other cases, a shorter period would make the most sense.
- *Update only*. Companies will be permitted, in filings after the initial registration statement, to provide only an update focused on material developments that have occurred since the most recent full discussion of the development of the business in a prior filing, including changes in the business strategy. Companies choosing this approach will need to provide an active hyperlink to incorporate the most recent filing that contains the full discussion, so that together the disclosure will provide the full discussion of the general development of the business. Only a single prior filing may be linked. The proposal is intended to eliminate repetitive disclosures and to help investors focus on material developments.

Observations and commentary

- Arguably, the historic evolution of the business is less of a focus for most companies than the description of the current business and the future-focused discussion of the vision, strategy and ambitions of the business. One possible result of the final amendments may be more focus on this description, especially with respect to crafting a discussion of material changes in strategy that provides all of the information that would reasonably be material to investors without disclosing information that is potentially proprietary or that would otherwise adversely affect the company's competitive position. As noted, the requirement to disclose material changes applies only if the strategy has previously been disclosed. Companies typically discuss their strategies in their IPO registration statements and, if they don't already do so, would now need to take into account the need to update their disclosures in the event of material changes in the future.

- Note that Item 1 of Form 10-K provides that the discussion of the development of the company's business need only include developments since the beginning of the fiscal year, which seems inconsistent with the new requirement to provide an update focused on material developments during the period over which information is material. Until there is some clarification from the staff, presumably, companies will comply with the requirement in the final amendments.
- The ability to "update only" may not turn out to be as valuable as it sounds on first blush. The SEC notes that, under SEC rules, "a filing that includes an update and incorporates by reference the more complete Item 101(a) discussion could not be incorporated by reference into a subsequent filing, such as a Form S-3 or Form S-4." Accordingly, the hyperlinking approach will, as a practical matter, be unavailable to companies that regularly access the public capital markets, and it otherwise remains to be seen how widely the hyperlinking approach will be adopted.

Business narrative (Item 101(c))

Regulation S-K requires a narrative description of the business done and intended to be done, focusing on the dominant segment or each reportable segment (if financial information is presented in the financial statements for those segments). Currently, the rule includes a long list of enumerated disclosure topics, many of which were adopted in 1973 and ripe for updating. While the current rule invokes a materiality standard, the SEC observed that many companies treat the list as mandatory. The SEC believes that shifting to a more principles-based framework might encourage companies to use their judgment to tailor the disclosure.

The more principles-based requirements include a list of disclosure topics, drawn from those in current Item 101(c), that are likely to be material to many companies, retaining the current distinction between segment disclosure topics (most of the topics) and topics to be discussed in the context of the business as a whole. The list excludes from the current list topics such as disclosure about working capital practices, new segments and dollar amount of firm backlog, although, if those topics were material, the company would still need to provide disclosure about them. To illustrate, a discussion of working capital practices would typically be more appropriate in MD&A unless, for example, supply chain finance arrangements were material to understanding a company's commercial relationships, in which case disclosure in the business narrative would be appropriate.

Principles-based list of disclosure topics – segments

The topics to be discussed by segment include the following:

- *Products and services – "Revenue-generating activities, products and/or services, and any dependence on revenue-generating activities, key products, services, product families or customers, including governmental customers."*

  The SEC viewed these elements as "key to how reasonable investors often evaluate the future prospects of a registrant's business."

- *Development and competition – "Status of development efforts for new or enhanced products, trends in market demand and competitive conditions."*

  This topic, although flexible and principles-based, may ultimately elicit more granular information than the current topic.

- *Resources – "Resources material to a registrant's business, such as:*

  (A) Sources and availability of raw materials; and

  (B) The duration and effect of all patents, trademarks, licenses, franchises and concessions held."

  Although one commenter suggested that companies be required to discuss how climate change will affect access to raw materials, the SEC rejected that idea, contending that a climate-change requirement was inconsistent with the principles-based nature of the regulation. Another commenter questioned the continuing relevance of disclosure regarding raw materials given the shift in the US economy away from manufacturing; nevertheless, the SEC elected to retain the requirement as proposed, explaining that companies need only discuss raw materials to the extent material. Even though intellectual property has become increasingly important to many businesses, the SEC elected not to expand the topic to add copyrights or trade secrets, largely because of competitive concerns and the substantial time and cost that might be involved in systematically identifying and cataloguing these types of intellectual property.

- *Government contracts – "A description of any material portion of the business that may be subject to renegotiation of profits or termination of contracts or subcontracts at the election of the Government."*

  The adopting release noted that companies with US government contracts already tend to disclose that the "funding of these contracts is subject to the availability of Congressional appropriations and that, as a result, long-term government contracts are partially funded initially with additional funds committed only as Congress makes further appropriations." In addition, the release observed that these companies disclose "that they may be required to maintain security clearances for facilities and personnel in order to protect classified information. Additionally, these registrants state that they may be subject to routine government audits and investigations, and any deficiencies or illegal activities identified during the audits or investigations may result in the forfeiture or suspension of payments and civil or criminal penalties."

- *Seasonality – "The extent to which the business is or may be seasonal."*

  The SEC decided to retain this topic to avoid a potential loss of information about seasonality in the fourth quarter because GAAP may not elicit this disclosure. In response to a comment suggesting that this topic require disclosure about the impact of climate change on seasonal businesses, the SEC once again rejected the idea "to avoid undermining the principles-based nature of Item 101(c)," noting that the "principles-based approach to this disclosure affords registrants sufficient flexibility to address relevant factors that may affect seasonality to the extent material to an understanding of the registrant's business."

Observations and commentary

- As noted above, both Lee and Crenshaw objected to the omission of any discussion of climate risk from the Description of Business. Lee contended that, by "some estimates, over 90% of US equities by market capitalization are exposed to material financial impact from climate change. We are long past the point at which it can be credibly asserted that climate risk is not material. We also know today that investors are not getting this material information." Crenshaw observed that the question of whether climate change risk is material is "no longer academic," considering, for example, the damage caused by the California fires and 2017 hurricane season. The SEC's "steps to modernize the securities laws should facilitate the efficient comparison of long-term sustainability in the face of present-day risks to issuers. But today's failure to address climate change risk continues to hamper the efficient sorting and comparison of modern companies."
- Similarly, in May, the SEC's Investor Advisory Committee observed that the issue of whether to mandate ESG disclosure, including climate, has been under consideration for about 50 years and advocated that it was time for the SEC to make a move. While recognizing the difficulties, the committee contended that "well-constructed, principles-based reporting that enables each Issuer, regardless of industry or business line, to set out its risks, strategies and opportunities in relation to material ESG factors should be no different than current disclosure of business risk, strategy and opportunity. ESG matters are part and parcel of the business of every Issuer and are unique to every Issuer."

Principles-based list of disclosure topics – company as a whole

The two topics identified below are intended to be discussed in the context of the company as a whole, unless material to a particular segment, in which case, the discussion should be extended to that segment as well:

- *Governmental regulation – "The material effects that compliance with government regulations, including environmental regulations, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries, including the estimated capital expenditures for environmental control facilities for the current fiscal year and any other material* *subsequent period."*

As amended, the item will expand the current mandated disclosure regarding the material impact of environmental regulations to cover all "material government regulations." The SEC observed that, although there is no separate requirement for disclosure about material government regulations, many companies do already provide that disclosure. Accordingly, the extension of the topic seemed consistent with current practice and will help provide investors with information material to an investment decision. The SEC emphasized, however, that the item "does not call for, or require, a recitation of every regulation that affects a registrant's business and operations."

- *Human capital – "A description of the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (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)."*

  The amended rule replaces the existing requirement to disclose only the number of employees with a requirement to disclose, to the extent material, information about human capital resources. In particular, the final amendments identify as non-exclusive examples of measures or objectives that the company may focus on in managing the business "measures and objectives that address the attraction, development, and retention of personnel." Even these measures, the SEC emphasized, are not a mandate.

Observations and commentary

- As Clayton made clear in his statement at the SEC meeting to consider approval of the final amendments, although, under the principles-based approach, the rules do not articulate specific metrics for human capital resources disclosure, he does "expect to see meaningful qualitative and quantitative disclosure, including, as appropriate, disclosure of metrics that companies actually use in managing their affairs." He noted here that, as with "non-GAAP financial measures, I would also expect companies to maintain metric definitions constant from period to period or to disclose prominently any changes to the metrics used or the definitions of those metrics." Accordingly, companies will need to think hard about what metrics to include in crafting their discussions of the "measures and objectives that address the attraction, development, and retention of personnel." Determining the measures and objectives may entail a process of looking through past public statements and considering board and management discussions as well as internal communications from Corporate and HR to the workforce and recruits. In this regard, any measures or objectives that are regularly reviewed and reported to the board and/or management would be clear candidates for disclosure under the principles-based approach. In addition, companies should look to their processes and initiatives concerning workforce issues such as health, safety and wellness, training and development, diversity and inclusion, pay equity, retention and recruitment, and any others that are designed to maintain and enhance the value of their human capital resources. For example, many companies have enhanced their disclosures regarding workforce health and safety measures in light of the COVID-19 pandemic, and we expect that workforce health and safety measures and objectives, including in light of COVID-19, will be included in these disclosures, particularly given the relevance of these disclosures to investors.
- In the proposing release, the SEC had asked for comment on whether the final rule should include more examples of measures or objectives that may be material, such as the number of full-time, part-time, seasonal and temporary workers; voluntary and involuntary turnover rates; measures regarding average hours of training per employee per year; information regarding human capital trends, such as competitive conditions and internal rates of hiring and promotion; measures regarding worker productivity; and the progress that management has made with respect to any objectives it has set regarding its human capital resources. But the SEC elected not to include more prescriptive requirements – or even these additional non-exclusive examples – because of its belief that the exact measures and objectives may vary significantly depending on the industry and the company, as well as "the then-current macro-economic and other conditions that affect human capital resources, such as national or global health matters." Nevertheless, even though the final amendments do not include these examples, the list may help identify some of the measures and objectives that companies could consider in crafting their own disclosures.
- The adopting release observed that a **rulemaking petition** requesting additional disclosure about human capital had received substantial support. Submitted in 2017 by the Human Capital Management Coalition, a group of 25 institutional investors with more than $2.8 trillion in assets under management, the petition asked the SEC to adopt rules requiring "issuers to disclose information about their human capital management policies, practices and performance." Although the petition was short on

prescriptive recommendations, it did identify the broad categories of information that the proponents viewed as "fundamental to human capital analysis." These categories, as well as the more truncated list of categories subsequently urged by the Coalition as explained below, may also help guide companies as they attempt to construct their human capital disclosures:

> 1. Workforce demographics (number of full-time and part-time workers, number of contingent workers, policies on and use of subcontracting and outsourcing)
> 2. Workforce stability (turnover (voluntary and involuntary), internal hire rate)
> 3. Workforce composition (diversity, pay equity policies/audits/ratios)
> 4. Workforce skills and capabilities (training, alignment with business strategy, skills gaps)
> 5. Workforce culture and empowerment (employee engagement, union representation, work-life initiatives)
> 6. Workforce health and safety (work-related injuries and fatalities, lost day rate)
> 7. Workforce productivity (return on cost of workforce, profit/revenue per full-time employee)
> 8. Human rights commitments and their implementation (principles used to evaluate risk, constituency consultation processes, supplier due diligence)
> 9. Workforce compensation and incentives (bonus metrics used for employees below the named executive officer level, measures to counterbalance risks created by incentives)

After adoption of the SEC's final amendments, the Coalition **issued a statement** observing that "under the new rules shareholders would still face difficulty in obtaining information that is clear, consistent, and comparable in order to make optimal investment and voting decisions. While the rulemaking represents important progress in acknowledging the importance of the workforce, the new rules give public companies too much latitude to determine the content and specificity of the human capital-related information they report." The Coalition looked forward "to working with the SEC to assist in developing a balanced approach to human capital-related reporting." In the statement, the Coalition also urged the SEC to require companies, at a minimum, to report on "four quantitative yet modest disclosures to anchor the principles-based, industry- and company-specific reporting framework relied upon in [the SEC's final] amendments": "(1) the number of employees, including full time, part-time and contingent labor; (2) total cost of the workforce; (3) turnover; and (4) employee diversity and inclusion."

- One of the objectives that companies may have set regarding their human capital resources is diversity and inclusion. In unscripted discussion at the end of the SEC meeting to consider adoption of the final amendments, Clayton noted that, as the principal executive officer of the SEC, the issue of diversity was important to him. The SEC valued diversity, inclusion and opportunity in words and action. As an example, he referred to the SEC's diversity and inclusion strategic plan, which reflects the SEC's collective recognition that diversity is not only the right thing, but also value-enhancing to the organization as a whole – a view shared by many institutional investors. In the same way, he expected that companies that believe their approaches to diversity, inclusion and opportunity to be material to their businesses and drivers of performance to disclose their approaches to these matters.
- The intense focus in 2020 on racial equality and justice (as well as meaningful progress made on gender diversity) has led investors and others to ramp up their focus on racial diversity on boards and throughout workforces. For example, during the summer, the New York City Comptroller sent letters to the CEOs of 67 S&P 100 companies asking them to "walk the walk" and publicly disclose the demographics of their employees by race, gender and ethnicity. In addition, Institutional Shareholder Services **sent a letter to multiple public companies** asking them to provide self-identified race and ethnicity information for all directors and named executive officers, and State Street has **called for companies** to provide diversity-related disclosures, including as they relate to strategy, goals, metrics, board practices and board oversight.
- At a recent roundtable with investors, Clayton and Corp Fin Director Bill Hinman heard investors clamor for more transparency regarding the composition of the workforce, discussion of "living wage" issues, and other issues regarding human capital in general. The investors also called for more holistic disclosure, including disclosure regarding social issues, such as the recent social upheaval arising out of racial inequality and injustice. How are companies addressing this issue? How are they addressing

diversity? One investor wanted more disclosure regarding the composition of the workforce, pointing to the SASB framework as a potential reference that would offer consistency without homogenization.

- Concern with human capital resources is not simply a response to societal challenges. Because of the intense competition for talent, asset manager BlackRock, for example, views each company's approach to human capital management as an investment issue and a "factor in business continuity and success. In light of evolving market trends like shortages of skilled labor, uneven wage growth, and technology that is transforming the labor market, many companies and investors consider robust HCM a competitive advantage." That view is shared by other institutional investors. For example, in its compilation of investors' top priorities for companies for 2018 (involving interviews with over 60 institutional investors with an aggregate of $32 trillion under management), EY identified HCM as one of investors' top five priorities. For many investors, EY reported, hiring and retention of the best talent can be key to remaining competitive over the long term, and company culture can play a role.

Smaller reporting companies (Item 101(h))

Currently, Item 101(h) provides alternative disclosure requirements for smaller reporting companies, applying a three-year timeframe. The SEC is *not* amending the more prescriptive alternative disclosure standards regarding business development, description of business and other information specified under Item 101(h)(1) through (6). This approach allows SRCs to provide a less detailed description of their businesses, consistent with the current scaled disclosure requirements for these companies. Notably, the human capital disclosure requirement in Item 101(h) is prescriptive, requiring only disclosure of the number of total employees and number of full-time employees. However, the SEC did make a couple of conforming changes.

- *Eliminate timeframe*. The SEC is eliminating the three-year timeframe for SRCs to describe the development of their businesses and directs SRCs to provide information for the period of time that is material to an understanding of the general development of the business. However, the SEC is retaining the requirement that SRCs that have not been in business for three years must provide the same information for their predecessors if there are any.
- *Updates*. As indicated above, for filings other than the initial registration statement, SRCs will be permitted to provide an update to the general development of the business disclosure, instead of a full discussion, along with an active hyperlink to the most recent filing containing the full discussion.

Legal proceedings (Item 103)

This item requires disclosure of any material pending legal proceedings, other than ordinary routine litigation, to which the company or any of its subsidiaries is a party or to which any of their property is the subject. Similar information is to be included for material legal proceedings known to be contemplated by governmental authorities.

- *Hyperlinks permitted*. Item 103 and GAAP have overlapping disclosure requirements. Although these requirements have different objectives and mandate different disclosure in some respects, much of the legal proceedings disclosure is often included in the notes to the financial statements or elsewhere in the document, such as in risk factors or MD&A. To discourage duplication, the final amendments expressly permit hyperlinks or cross-references to legal proceedings disclosure located elsewhere in the document.
- *Disclosure threshold.* Currently, companies are not required to disclose environmental proceedings to which the government is a party if they reasonably believe that monetary sanctions will be less than $100,000, a threshold that dates back to 1982. The final amendments raise the prescribed disclosure threshold, based on the CPI Inflation Calculator, to $300,000. However, the SEC also recognized that a single numerical threshold could lead to some disclosures that are not material, especially for larger companies. Accordingly, in a change from the proposal, the final amendments add flexibility by adopting a hybrid approach that allows the company to select a different threshold that it determines is reasonably designed to result in disclosure of material environmental proceedings – so long as the threshold selected does not exceed the lesser of $1 million or 1% of the current assets of the company and its subsidiaries on a consolidated basis. If a company chooses to use a threshold other than $300,000, it must disclose this threshold (including any changes) in each annual and quarterly report. The SEC believes that these "parameters, together with the bright-line $300,000 threshold, are intended to ensure that investors continue to receive

relevant information about environmental sanctions while also realizing the benefits of a more principles-based approach."

Observations and commentary

- It is worth noting that the financial statements are not covered by the safe harbor from liability for forward-looking statements provided by the Private Securities Litigation Reform Act. The safe harbor does, however, cover litigation disclosures elsewhere in a Form 10-K or similar filing to which the PSLRA would apply. To the extent that companies want to include forward-looking information in their disclosures regarding litigation, they may want to consider including it in portions of the document outside of the financial statements.

Risk factors (Item 105)

Currently, this principles-based item requires disclosure of the "most significant" factors that make the investment speculative or risky and how the risk affects the company or the securities.

- *Mandatory summary as an incentive.* Under the final amendments, if the risk factor section exceeds 15 pages, the company must include, in the forepart of the document, a summary, not to exceed two pages, consisting of "a series of concise, bulleted or numbered statements summarizing the principal factors that make an investment in the registrant or offering speculative or risky." The SEC believes the prescribed format "will avoid concerns that the requirement could lead to lengthy summaries or result in investors discounting the full risk factor presentation," and that the page limitation will lessen the company's burden and provide an incentive "to give due consideration to the risk factors that are material to investors." A summary, the SEC contends, will not only "enhance the readability and usefulness of the disclosure for investors," it may also serve as "an incentive for registrants to reduce the length of their risk factor discussion to avoid triggering the summary requirement, to the extent that such an incentive outweighs perceived litigation risks." The SEC estimates that about 40% of current filers will be affected.
- *Materiality standard*. The final amendments change the current disclosure standard from "most significant" factors to "material" factors, with the goal of focusing companies "on disclosing the risks to which reasonable investors would attach importance in making investment or voting decisions" and encouraging companies to tailor their risks. The SEC observed that the term "material" as used in Item 105 is defined in Rule 12b-2 and Rule 405.
- *Organization*. The SEC will now require companies to organize the risk factors under relevant headings, an already common practice, with risks that could apply generally to any company or offering of securities – where the company does not explain the specific relationship of the risk to the company or the offering – to be located at the end under a separate caption, "General Risk Factors." The final amendments do not require companies to prioritize the order in which they discuss their risk factors.

Observations and commentary

- The SEC has long grumbled about "the lengthy and generic nature of the risk factor disclosure presented by many registrants," which, studies have shown, has recently increased. For example, "one study found that registrants increased the length of risk factor disclosures from 2006 to 2014 by more than 50 percent in terms of word count, compared to the word count in other sections of Form 10-K that increased only by about 10 percent, and that this increase in risk factor word count may not be associated with better disclosure." The SEC considers the inclusion of untailored, generic risks to be a contributing factor, clearly discouraged that, notwithstanding SEC and staff guidance to limit risks to those that are "most significant," the practice of including boilerplate risks has continued. Commenters in response to the Concept Release "attributed the growing length of risk factor disclosure to the fear of litigation for failing to disclose risks if events turn negative." Commissioner Hester Peirce **considered the mandated summary** to be something of an experiment, wondering whether "the penalty of having to prepare a summary [would] be sufficient to overcome the fear of litigation that pushes companies to disclose many pages of risks?" Given that the difficulty of shortening risk factors to 15 pages – especially those risk factor sections that may exceed 50 pages in length – would usually be substantially greater than the difficulty of creating a bullet-point summary, as well as the prevailing concern regarding liability risk if the risk factors turn out to be incomplete, we expect to see a lot of risk factor summaries going forward.

- As the SEC notes, the model for the summary was the risk factor summary included in a Form S-11, which typically consists of a series of bulleted or numbered statements that do not exceed a page in length. Similarly, we expect many companies will pattern their risk factor summaries on the risk factor component of the summaries included in their IPO prospectuses. In addition, as the SEC pointed out in the adopting release, "[b]ecause the risk summary is not required to contain all of the risk factors identified in the full risk factor discussion, registrants may prioritize certain risks and omit others."
- In response to concerns expressed that classifying some risk factors as generic under a "General Risk Factors" category could potentially increase litigation risk, the SEC noted that companies could "tailor their risk factor disclosures to emphasize the specific relationship of the risk to the registrant or the offering and therefore avoid the need to include the risk under the general risk heading," leaving the door open for companies to omit a "General Risk Factors" category entirely.

If you have any questions, please contact one of your Cooley team members or one of the attorneys identified here.

Appendix A

Regulation S-K Item	Summary of Existing Item Requirements	Summary of the Final Amendments

Appendix A

Regulation S-K Item	Summary of Existing Item Requirements	Summary of the Final Amendments
Item 101(a) and (h)	Requires a description of the general development of the business of the registrant during the past five years, or such shorter period as the registrant may have been engaged in business.	Revises Item 101(a) to: ▪ Be largely principles-based, requiring disclosure of information material to an understanding of the general development of the business, and eliminating the previously prescribed five-year timeframe. Revises Item 101(h) to: ▪ Eliminate the three-year timeframe with respect to smaller reporting companies. Revises Items 101(a) and (h) to clarify that: ▪ Registrants, in filings made after a registrant's initial filing, may provide an update of 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 registrant's most recent filing containing a full discussion of the general development of its business, and incorporate by reference that prior discussion.

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Regulation S-K Item	Summary of Existing Item Requirements	Summary of the Final Amendments
Item 101(c)	Requires a narrative description of the business done and intended to be done by the registrant and its subsidiaries, focusing upon the registrant's dominant segment or each reportable segment about which financial information is presented in its financial statements. To the extent material to an understanding of the registrant's business taken as a whole, the description of each such segment must include disclosure of several specific matters.	Revises Item 101(c) to: ▪ Clarify and expand the principles-based approach of Item 101(c), with a non-exclusive list of disclosure topic examples (drawn in part from the topics currently contained in Item 101(c)); ▪ Include, as a disclosure topic, a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business; and ▪ Refocus the regulatory compliance disclosure requirement by including as a topic all material government regulations, not just environmental laws.

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Regulation S-K Item	Summary of Existing Item Requirements	Summary of the Final Amendments
Item 103	Requires disclosure of any material pending legal proceedings including the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Similar information is to be included for any such proceedings known to be contemplated by governmental authorities. Contains a threshold for disclosure based on a specified dollar amount ($100,000) for proceedings related to federal, state or local environmental protection laws.	Revises Item 103 to: ▪ Expressly state that the required information may be provided by hyperlink or cross-reference to legal proceedings disclosure located elsewhere in the document to avoid duplicative disclosure; and ▪ Implements a modified disclosure threshold that increases the existing quantitative threshold for disclosure of environmental proceedings to which the government is a party from $100,000 to $300,000, but that also affords a registrant the flexibility to select a different threshold that it determines is reasonably designed to result in disclosure of material environmental proceedings, provided that the threshold does not exceed the lesser of $1 million or 1% of the current assets of the registrant and its subsidiaries on a consolidated basis.

Appendix A

Regulation S-K Item	Summary of Existing Item Requirements	Summary of the Final Amendments
Item 105	Requires disclosure of the most significant factors that make an investment in the registrant or offering speculative or risky and specifies that the discussion should be concise, organized logically and furnished in plain English. The Item also states that registrants should set forth each risk factor under a subcaption that adequately describes the risk. Additionally, Item 105 directs registrants to explain how each risk affects the registrant or the securities being offered and discourages disclosure of risks that could apply to any registrant.	Revises Item 105 to: ▪ Require summary risk factor disclosure of no more than two pages if the risk factor section exceeds 15 pages; ▪ Refine the principles-based approach of Item 105 by requiring disclosure of "material" risk factors; and ▪ Require risk factors to be organized under relevant headings in addition to the subcaptions currently required, with any risk factors that may generally apply to an investment in securities disclosed at the end of the risk factor section under a separate caption.

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