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To the Point

SEC – proposed guidance

SEC proposes further modernization of Regulation S-K disclosure requirements

The proposal aims to improve the readability of disclosures, while discouraging the inclusion of redundant or immaterial disclosures.

What you need to know

- The SEC proposed amending its disclosure requirements for the description of business, legal proceedings and risk factors.
- The proposal takes a more principles-based approach to disclosing the description of business and risk factors to give registrants more flexibility in how they comply.
- The proposal would require disclosures about human capital resources and the related measures or objectives on which management focuses, if material.
- Comments are due within 60 days of publication in the Federal Register.

Overview

The Securities and Exchange Commission (SEC) **proposed** further amendments to its rules under Regulation S-K that would modernize the required disclosures for the description of business, legal proceedings and risk factors.

The proposal is intended to reduce the burden of preparing the disclosures and provide investors with more meaningful disclosures. It is part of the SEC's disclosure effectiveness initiative and follows its adoption of a final rule in May 2019 to modernize and simplify certain other requirements in Regulation S-K.

"The proposals reflect a thoughtful mix of prescriptive and principles-based requirements that should result in improved disclosures and the elimination of unnecessary costs and burdens," SEC Chairman Jay Clayton said.

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Key considerations

Description of business, including human capital resources

The proposal calls for a more principles-based approach to describing the business under Item 101 of Regulation S-K. The SEC stated that providing registrants more flexibility to tailor these disclosures to their circumstances may elicit more relevant information.

The proposal would eliminate the prescribed five-year timeframe to discuss the development of the registrant's business and instead provide flexibility based on the company's facts and circumstances. After an initial registration statement, the proposal would permit only material updates in subsequent filings with a hyperlink to the most recently filed disclosure that, together with the update, would present a complete discussion. This would permit existing registrants to provide disclosures only about material developments since the latest comprehensive discussion. The proposal would also require companies to disclose any material changes to a previously disclosed business strategy.

The proposed amendments would provide a nonexclusive list of disclosure topics that would require responsive disclosures only if they are material to an understanding of the registrant's business taken as a whole. Currently, companies are required to disclose 10 prescribed items about their business. The proposal would expand the topic related to compliance with environmental laws to include compliance with all material government regulations. The SEC believes this would align to the current reporting practice of many registrants.

The SEC recognizes exact measures or objectives included in a registrant's human capital resource disclosure may change over time and depend on the registrant's industry.

The proposal also would call for enhanced human capital disclosures. The SEC noted that "intangible assets represent an essential resource for many companies, [and] human capital may represent an important resource and driver of performance."

Responsive disclosures would be required to include a description of human capital resources and any related measures or objectives on which management focuses, to the extent material to an understanding of the business. The proposed rule includes nonexclusive examples of human capital measures and objectives that may be material (e.g., measures on personnel attraction, development and/or retention), rather than prescribing specific measures to be disclosed by all registrants.

How we see it

Notably, this is the first time the SEC has required any human capital metrics beyond headcount and unionization. The Commission's proposal is consistent with its Investor Advisory Committee's recent recommendation that "any [human capital disclosure] requirements should be crafted so as to reflect the varied circumstances of different businesses, and to eschew simple 'one-size-fits-all' approaches that obscure more than they add."

The SEC's proposal references some of the human capital metrics included in the 2018 report from the EY co-created Embankment Project for Inclusive Capitalism (EPIC), which identified value drivers important for sustainable and inclusive growth as well as potential metrics to assess them.

At a recent SEC roundtable,[1] we expressed our support for changes to the SEC's disclosure regime that could create more balance between short-term results and longer-term performance.

Legal proceedings

The proposal retains the prescriptive approach to the legal proceedings disclosures under Item 103 of Regulation S-K, which requires a discussion of any material pending legal proceedings involving the registrant. To prevent redundancy, the proposal would explicitly permit required information on legal proceedings to be hyperlinked or cross-referenced from other disclosures elsewhere in the same filing (e.g., financial statement footnotes).

The proposal would also retain the existing bright line disclosure threshold (i.e., 10% of current assets), but it would increase the threshold applicable to environmental proceedings to which a governmental authority is a party to $300,000 from $100,000, consistent with inflation.

How we see it

The SEC had previously considered referring certain of the requirements on legal proceedings disclosures under Regulation S-K to the Financial Accounting Standards Board for incorporation into Accounting Standards Codification (ASC) 450, *Contingencies*. We and other commenters objected to that approach, and the SEC decided to retain the current requirements with only minor modifications.

The proposed approach would give companies flexibility to streamline their disclosures while balancing the different objectives of Regulation S-K and ASC 450.

Risk factors

The proposed changes to the Item 105 disclosures of risk factors would require companies to report "material" factors, rather than the "most significant" factors. If a filing's risk factors section exceeds 15 pages, the registrant would have to provide a summary risk factor disclosure. The SEC estimates this proposed change would affect 40% of current filers. These changes are intended to address the lengthy and generic nature of the existing risk factors presented by many registrants.

Risks that could apply generically to any registrant would have to be presented at the end of the Item 105 disclosure in a general risk factors section. The SEC believes these changes would focus registrants on disclosing the risks unique to them that investors would consider important in making investment decisions.

Endnote:

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[1] SEC Roundtable, ***Spotlight on Short and Long-Term Management of Public Companies***. 18 July 2019.