

Alert | Corporate



September 2020

SEC Modernizes Business, Legal Proceedings, and Risk Factor Disclosures

On Aug. 26, 2020, by a 3-2 vote, the Securities and Exchange Commission (SEC) **adopted amendments** to modernize several of the disclosure requirements for business descriptions, legal proceedings, and risk factors pursuant to Regulation S-K. The amendments are part of the SEC's ongoing Disclosure Effectiveness Initiative, which aims to modernize and simplify the disclosures that registrants are required to include in their SEC filings.

Development & Description of the Business

The amendments to Item 101 of Regulation S-K represent a shift to a largely principles-based approach to business disclosures. These changes will alter how many registrants describe their business, disclose business developments, and discuss their human capital resources.

General Development of Business

Previously, Item 101(a) required registrants to describe the general development of the business (along with subsidiaries and predecessors) in the past five years and “for earlier periods if material to an understanding of the general development of the business.” As amended, this item now requires registrants to disclose information that is material to an understanding of the general development of the business, eliminating the specific five-year timeframe. The amendments to Item 101(a) also permit registrants to provide only an update of their business development disclosure, with a focus on material

developments during the reporting period, and incorporate the full discussion in a prior filing by reference using a hyperlink. While the principles-based approach is designed to be adaptive to different businesses, the SEC provided a non-exclusive list of four types of information for registrants to consider when making disclosures under amended Item 101(a) of Regulation S-K:

- material changes to a previously disclosed business strategy;
- material bankruptcy, receivership, or any similar proceeding;
- the nature and results of any material reclassification, merger, or consolidation of the registrant or any of its significant subsidiaries; and
- the acquisition or disposition of any material amount of assets not in the ordinary course of business.

Description of Business

Previously, Item 101(c) required registrants to describe “the business done and intended to be done . . . focusing upon the registrant’s dominant segment or each reportable segment” and identified specific line-item topics that were required to be discussed. Through the principles-based amendments, Item 101(c) now includes a non-exclusive list of disclosure topics that registrants are required to discuss in the context of their business description, but only to the extent material to an understanding of the company’s business. One notable change to that list was the inclusion of a discussion, if material, of the material effects of compliance with all government regulations, rather than just environmental laws as previously limited, recognizing that many companies already voluntarily provide such disclosure.

Human Capital Disclosures

Additionally, amended Item 101(c) now requires registrants to consider including disclosures regarding human capital resources in their business description. This new disclosure would include, to the extent material to an understanding of a registrant’s business, the number of employees and any human capital measures or objectives that the registrant focuses on in managing the business (such as measures or objectives related to development, attraction, and retention of personnel). In its [adopting release](#), the SEC emphasized that human capital is a material resource and factor of performance for many companies and that, in many cases, such disclosure provides important information for investors. SEC Chairman Jay Clayton also highlighted the SEC’s view that human capital can be a long-term value driver for various industries and companies.

Small Reporting Companies

For smaller reporting companies (SRCs), the SEC amended Item 101(h) of Regulation S-K to eliminate the requirement that SRCs describe the development of their business over the last three years. Similar to other registrants under the amended Item 101(a), an SRC may now forgo providing this full discussion in filings other than an initial registration statement by (1) providing an update on all of the material developments that have occurred since the most recent registration statement or report containing a full discussion of business developments, (2) providing a hyperlink to such statement or report that includes the full discussion and (3) incorporating the full discussion into the filing.

Legal Proceedings

Item 103 of Regulation S-K requires registrants to provide a brief description of “any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject,” as well as any such proceedings known to be contemplated by governmental authorities. In order to reduce duplicative disclosures, the Item 103 amendments allow for a cross-reference or hyperlink to another section of the filing that contains a discussion of this information. These amendments also raise the threshold for required disclosure of environmental proceedings from \$100,000 to \$300,000. These amendments also provide a registrant the flexibility to select an alternative threshold when:

- the registrant determines the alternative threshold is reasonably designed to result in disclosure of any such proceeding that is material to the business or financial condition; and
- the registrant discloses the alternative threshold (including any change thereto) in each annual and quarterly report.

Notwithstanding the selection of an alternative threshold, disclosure will be required for any proceeding when potential monetary sanctions exceed the lesser of \$1 million or 1% of the current assets of the company and its subsidiaries on a consolidated basis.

Risk Factors

Previously, Item 105 of Regulation S-K required disclosure of “the most significant factors that make an investment in the registrant or offering speculative or risky.” Through its amendments, the SEC sought to address a trend of increasing length and generality of risk factor disclosures.

New Summary Requirement

Under amended Item 105, if a registrant’s risk factor discussion exceeds 15 pages in length, the registrant will be required to provide a concise summary of the principal risk factors. This summary must be no more than two pages long and must appear in the forepart of an annual report or prospectus.

Organization of Risk Factors Disclosure

The amendments to Item 105 also require registrants to organize and group their risk factor disclosures under relevant headings in addition to the subcaptions currently required. However, any risk factors that could apply generally to other companies or investment in securities must be grouped together at the end of the risk factor section under a separate “General Risk Factors” caption.

Foreign Private Issuers

Foreign private issuers will also be impacted by the amendments to Item 105, as that item is required by registration statement Forms F-1, F-3 and F-4. However, the amendments to Items 101 and 103 will affect only domestic registrants and those foreign private issuers that have elected to file on domestic forms subject to Regulation S-K disclosure requirements. The SEC declined to adopt similar amendments to the business and legal disclosure requirements of Form 20-F, citing the potential for added reporting costs, reduced ability to use a single disclosure document in multiple jurisdictions, and additional burden on smaller registrants with limited resources. Foreign private issuers should continue to refer to the disclosure requirements of Item 4 (Information on the Company) and Item 8.A.7 (Legal Proceedings) of Form 20-F.

Key Takeaways

These amendments will become effective 30 days after their publication in the Federal Register. For calendar-year companies, these amendments could be in effect prior to their upcoming quarterly reporting deadlines; therefore, they should consider the changes in preparing their third quarter Form 10-Q. While the changes to the business disclosure requirements may not impact registrants until their next annual report on Form 10-K or certain registration statements filed under the Securities Act of 1933, companies should begin to consider how they plan to modify their disclosures in light of the amendments. In addition, companies should start considering whether they will be required to include a discussion of human capital resources, given its broad applicability across companies and industries and in light of the heightened public interest regarding human capital matters that has been spurred by the COVID-19 pandemic. This discussion may also become particularly significant in the ever-evolving corporate environmental, social and governance (ESG) context, given the continued push by institutional investors for ESG-related disclosures in companies' SEC filings.

As many companies have supplemented their risk factors to address the impacts of the COVID-19 pandemic, those that expect to have risk factor disclosures that span more than 15 pages will face a choice. While some companies may decide to develop a more concise discussion of their risks to avoid the summary requirement, this decision must be weighed against the potential litigation regarding claims that the company's risk factor disclosure is deficient. Companies with longer risk factor discussions should begin the initial process of developing their summary of principal risk factors as required by amended Item 105.

The existing requirements and the new requirements are summarized below:

| Regulation S-K Item | Summary of Existing Requirements | Summary of Amendment Impacts |
|---|---|---|
| <p>Item 101(a)</p> <p>General Development of the Business</p> | <p>Requires 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).</p> | <p>Requires disclosure of information to the extent material to an understanding of the general development of the business. If material, disclosure should include any material changes to a previously disclosed business strategy.</p> <p>Eliminates the previously prescribed five-year timeframe.</p> <p>Allows registrants to provide only an update of the general development of the business (rather than a full discussion) in filings made after a registrant’s initial filing. The update must disclose all of the material developments that have occurred since the registrant’s most recent filing containing a full discussion and incorporate by reference (or hyperlink) that prior discussion.</p> |
| <p>Item 101(c)</p> <p>Narrative Description of the Business</p> | <p>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.</p> <p>The description of each such segment must include 10 specific matters, to the extent material to an understanding of the registrant’s business as a whole:</p> <ol style="list-style-type: none"> 1. Principal products produced and services rendered; 2. New products or segments; 3. Sources and availability of raw materials; 4. Intellectual property; | <p>Revises Item 101(c) to clarify and expand the principles-based approach of Item 101(c), with a non-exclusive list of information that the SEC believes generally would be material for an understanding of the business of each segment:</p> <ol style="list-style-type: none"> 1. Revenue-generating activities, products and/or services; and any dependence on key products, services, product families or customers, including governmental customers; 2. Status of development efforts for new products, trends in market demand, and competitive conditions; 3. Resources material to the business; including the availability of raw materials and the duration and |

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| | <p>5. Seasonality of the business;</p> <p>6. Working capital practices;</p> <p>7. Dependence on certain customers;</p> <p>8. Dollar amount of backlog orders believed to be firm;</p> <p>9. Business subject to renegotiation or termination of government contracts;</p> <p>10. Competitive conditions.</p> <p>Item 101(c) also specifies two additional items that must be discussed with respect to the registrant’s business in general:</p> <p>11. The material effects of compliance with environmental laws; and</p> <p>12. Number of persons employed.</p> | <p>effect of all patents, trademarks, licenses, franchises, and concessions held;</p> <p>4. Any material portion of the business that may be subject to renegotiation of profits or termination of contracts by the government; and</p> <p>5. Seasonality of the business.</p> <p>Adds 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 as a whole.</p> <p>Broadens the regulatory compliance disclosure requirement to include all material government regulations that would be material to an understanding of the registrant’s business as a whole.</p> |
| <p>Item 101(h)</p> <p>Smaller Reporting Companies (SRCs)</p> | <p>Requires SRCs to provide a description of the general development of the business during the past three years (or such shorter period as the registrant may have been engaged in business).</p> | <p>Eliminates the three-year timeframe with respect to SRCs.</p> <p>Allows registrants to provide only an update of the general development of the business (rather than a full discussion) in filings made after a registrant’s initial filing. The update must disclose all of the material developments that have occurred since the registrant’s most recent filing containing a full discussion and incorporate by reference (or hyperlink) that prior discussion.</p> |
| <p>Item 103</p> <p>Legal Proceedings</p> | <p>Requires disclosure of any material pending legal proceedings including:</p> <ol style="list-style-type: none"> 1. the name of the court or agency in which the proceedings are pending; 2. the date instituted; | <p>Allows the required information to be provided by hyperlink or cross-reference to legal proceedings disclosure located elsewhere in the document to avoid duplicative disclosure.</p> |

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| | <p>3. the principal parties thereto;</p> <p>4. description of the factual basis of the allegations; and</p> <p>5. the relief sought.</p> <p>Similar information is to be included for any such proceedings known to be contemplated by governmental authorities.</p> <p>Contains a threshold for disclosure based on a specified dollar amount of \$100,000 for disclosure of environmental proceedings involving monetary sanctions and the government as a party.</p> | <p>Increases the quantitative disclosure threshold for environmental proceedings where the government is a party to \$300,000.</p> <p>Implements a modified disclosure threshold that allows 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: (a) \$1 million or (b) 1% of the current assets of the registrant and its subsidiaries on a consolidated basis.</p> |
| <p>Item 105</p> <p>Risk Factors</p> | <p>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.</p> <p>Recommends that registrants set forth each risk factor under a subcaption that adequately describes the risk.</p> <p>Directs registrants to explain how each risk affects its business or the securities being offered and discourages disclosure of risks that could apply to any registrant.</p> | <p>Requires a summary risk factor disclosure of no more than two pages in the forepart of the filing if the risk factor section exceeds 15 pages.</p> <p>Requires risk factors to be organized under relevant headings, with any risk factors that may generally apply to an investment in securities disclosed at the end of the risk factor section under the caption “General Risk Factors.”</p> <p>Requires disclosure of only “material” risk factors, under the principles-based approach.</p> |

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