

Business Better (Episode 11): A Discussion on the New SEC Disclosure Rules

Speakers: John Wright, Naz Jalali, Mary Mullany

John Wright:

Welcome to Better Business. A podcast designed to help businesses navigate the new normal. I'm your host John Wright. For nearly 15 years, I was senior vice president and general counsel at Triumph Group, Inc. a global aerospace components supplier. I'm now a member of the Securities and M and A groups at Ballard Spahr, a national law firm with clients across industries and across the country. On today's episode, we'll be discussing final rules recently adopted by the US securities and exchange commission to modernize the business legal proceedings and risk factor disclosures required in SEC Annual and Quarterly Reports and offering documents.

John Wright:

We reviewed the key changes made, their significance, some open questions left by the rules and how companies might best go about responding to the change to disclosure requirements. To cover these topics, I'm delighted to be joined by my colleagues, Mary Mullany and Naz Jalali. Both of whom are members of Ballard Spahr, Securities and Capital Markets Group. Mary Mullany is a partner of the firm. She concentrates her practice in the areas of securities disclosure, capital raising, mergers and acquisitions, executive compensation and corporate governance. Many of her clients are in the life sciences and medical device industries.

John Wright:

Naz Jalali is at counsel at the firm. Naz advises public companies on corporate governance matters, securities law compliance and capital raising transactions. She has worked with companies in the gaming, specialty products and utilities industries among others. Mary and Naz, welcome to Business Better.

Naz Jalali:

Thanks John. Happy to be here.

Mary Mullany:

Thanks very much, John. We look forward to it.

John Wright:

So supposing the most of our listeners are those who work with the SECs disclosure rules, either as lawyers, accountants, or financial folks who helped draft the disclosure or board or audit committee members who review it. Mary, could you start us out with an overview of which disclosure items are covered by the rule changes and the general significance of the amendments?

Mary Mullany:

Sure. What the SEC did with these final rules is provide disclosure changes in certain items of regulation as K, which is the outline or framework for all disclosure obligations. The three items that were affected by these are

section 101 of Regulation S-K, 103 and 105. Those are the business description in 101, the description of legal proceedings required under 103. And then all of our favorite, the risk factor disclosure in item 105. And this is the first time in 30 years that the SEC has actually made any real significant change to the business description in particular. It has been a long time coming. This process started all the way back with the JOBS Act and a study commissioned by the SEC, they provided concept release and then proposed rules.

Mary Mullany:

It's been going on for quite some time. And as we'll talk about a little bit more later and we've all been reading all of these JOBS Act requirements, the concept release and other things, some of it is really not a surprise. The effective date for the filing is November 9th, which is 30 days after it was published in the Federal Register. We're in the middle of 10-Q time, which means anyone who files their 10-Q before 5:30 PM on November 6th, which is a Friday, is under the old regime and starting with the ones that are a little bit late, 5:31 on November 6th, you're subject to the new rules.

John Wright:

Before I give our listeners an overview of what we're going to cover on the podcast, I should know that we're recording this podcast on October 29th. The effective date of the new rules hasn't arrived yet but by the time some of our listeners will be tuning in, it will have come and gone. Now obviously, there's a lot we could cover but we're only intending to provide an overview or an introduction to the new rules.

John Wright:

I should know that we planned to devote maybe a majority of the time to the changes in item 101 regarding the description of the business, which are a little more extensive and then allocate the remainder of the time to the other two sections segwaying first in to the changes and risk factor disclosure before finally covering the changes in disclosing legal proceedings. I also note that we'll try to mention a few practice steps that were coming still on the way and note some issues that are left open in the new rules. So with that background, Mary, what are the principle changes in the business description disclosure generally?

Mary Mullany:

The biggest one to start with John, is that historically, the SEC has required companies to provide a five-year look back on their business disclosure. For smaller reporting companies, the period of time is a three-year look back. And as I mentioned before with the concept early, send some of the other things they've been signaling that that kind of route time requirement maybe something that will go away. And in fact, it has been eliminated. And it's been eliminated in exchange for a disclosure of the business. That is a principles-based disclosure, that discloses information material to an understanding of the business development generally, and not just for a set period of time.

John Wright:

You referred to a principles-based disclosure, can you explain that a little bit for our listeners?

Mary Mullany:

Sure. I think we're all familiar SEC disclosure practitioners with the concept of principles-based because it's in management's discussion and analysis section of these disclosure documents, we've been dealing with that for years. And also in the compensation, discussion and analysis, it's really kind of identifying for the business managers, the

concept of what are the principle issues that drive your business? And what are the things you think about? What are the things that impact your business the most and how do you frame your disclosure around those principles and material information, which is very different than I would say, just making sure that you have the subheadings that follow the previous rule 101 framework rules.

Mary Mullany:

And I would mention that one of the concerns that has been identified by practitioners as they read this, is the concern that it gives executives some pretty broad discretion as to how they can frame this principles-based decision and our investors who are reading these disclosure documents going to be able to easily compare perhaps across an industry with inconsistent disclosures based on these principles, based on so would it make the investment analysis more difficult to do. That's very much an open question but it's something certainly to consider.

John Wright:

How do you expect this to play out year after year as you comply with the rules going forward?

Naz Jalali:

Companies will ... first they may need to update their disclosure controls and procedures to make sure they're gathering the necessary information to account for this principal-based disclosure because it's a lot more judgment based now. And we expect that non-disclosures will evolve over time and some companies may view this as an opportunity to revisit and revamp their business section while others may just sort of take a wait and see approach and wait until some practice has developed on this point. One of the things that the real teams also did, was they allowed after an initial filing, a company now has the option to update its business description disclosure without having to do the fulsome disclosure that you would initially.

Naz Jalali:

So essentially, there is this update option now where you can update your disclosure document, the most material developments since your last fulsome disclosure. Now, I don't know how that is going to play out in practice because it's a little unwieldy because in order to take advantage of this rule, you have to incorporate by reference to the prior disclosure. And that requires revisiting that disclosure and making sure that there's nothing in there that's stale. So it may end up being not worth the effort of taking advantage of the update option for a lot of companies. And there's also a concern about double incorporation by reference.

Naz Jalali:

You can't incorporate by reference to a document that in and of itself incorporates by reference to something else. I think there's an open question as to whether, if you take advantage of this update option, what does that mean for subsequent list disclosure, like in particular with shelf registration statements and formats threes, where you're required to incorporate by reference to a full business disclosure. That is something that remains to be seen. Hopefully, the SEC will provide guidance on this.

Mary Mullany:

Yeah. If I could use an example on that and most companies are going to be using or doing their initial disclosure under these new rules for the business description in the form 10-K for 2020, which will be filed in February or March of 2021. Let's say, this as a company with a three-year shelf registration statement that is going to expire in May of 2022. Once they get to 2022 and are doing their 2021 form 10-K, if they were to decide to look back and

incorporate by reference their entire business description from their 2020 form 10-K and you do have to incorporate the entire description, you can't pick and choose. So if they would do that, then their shelf registration statement, which incorporates the 2021 form 10-K then has this double incorporation by reference that Naz talked about.

Mary Mullany:

So we think unless the SEC really addresses this, the likelihood that people will take advantage of the update feature is probably pretty limited. Because to me, I don't know that I think a lot of people will take advantage of it. Anyway, if the idea is that you're supposed to really be talking about your business from a principles-based matter and how you're looking at it right now, discloser goes stale so quickly, even if there's a lot of it that maybe fundamentally is the same. It changes year over year. So I don't know how useful I think this is.

John Wright:

Okay, so we've covered the key changes in item 101 A and its requirements relating to the description of the development of the business. Let's start with the changes in item 101 C and its list of non-exclusive segment level disclosure items that a company was supposed to address. What changes did the SEC make here?

Naz Jalali:

Well, the list remains principally the same. I think that the difference is that instead of "Shall", it's now a "May" and there's an overlay of the principles-based materiality threshold that Mary talked about so that's the backdrop. Companies should still discuss things like revenue generating activities, development of new products, competition, seasonality, as long as it's material to their business. I think it's more of, now it's a permissive list as opposed to what was viewed as more of a mandatory list of topics to discuss. And I think one other significant change that I know we'll discuss in more detail, is that one other disclosure topics is that company's discussion of human and capital resources and measures that the company focuses on, on managing its business. That's a significant change that I think we will get into more detail about.

Mary Mullany:

And then other things that we'll talk about a bit more are the refocusing of the regulatory disclosure to include the impact of all compliance with material, governmental regulation, not just environmental. The discussion of the resources that may be material to the company's business, such as raw materials or intellectual property. And again focused with the principles-based disclosure nature of those discussions. And as Naz mentioned the seasonal nature of the business and that was one item that the comments seem to suggest maybe could come out but ended up staying on in the same place. And this is one of the items where the SEC talked about that they were leaving it in, perhaps for some guidance on climate change related disclosure, which they did decide not to address in these rules, which I think is an important concept to remember.

John Wright:

I noted that the new rules and the adopting release addressed company disclosure of business strategy. Can you give us an explanation of how business strategy disclosure has been handled under the new rules?

Mary Mullany:

Sure. To the extent that a registering does disclose its business strategy, the new rules require an update to that. If it's material to understand the development of the business. A specific line item for strategy and planning really did

come through from the JOBS Act, the concept release and many companies have been doing this for quite some time. I don't think this is a big change I have for a lot of companies but it does require really careful review so that if your strategy does change in any significant way that will trigger a disclosure requirement.

Mary Mullany:

And certainly, that may impact as we talked about before, whether or not you think you can incorporate by reference. And do you really want to do an update that says, Oh, by the way, we've completely changed our strategic focus. Now we're going to just tell you only about that. I think that's an example of a place where that might come into play. And some things in the strategic discussion in the business section, is I wouldn't repeat items that need to be addressed in management's discussion and analysis, because we are all still trying to limit the repetition in our filings.

John Wright:

What's remained the same in these new rules?

Naz Jalali:

After considering some comments, the SEC kept the disclosure obligations in describing the development of the business when it comes to things like bankruptcy, receiverships, seminal proceedings and material reclassification, merger, or consolidation of assets. These are items the SEC viewed as important to mandate disclosure.

John Wright:

There are a couple of topics that appear to be more extensively changed. And you've alluded to a couple of them already. One of these is government regulation disclosure, can you explain the changes made in this area?

Mary Mullany:

Sure. I find this to be one of the places that really is something that makes this requirement more relevant to many more companies. Before the disclosure was really limited to environmental regulation. And you would see companies whether or not environmental regulation was really significant to their business with sometimes pages of environmental regulation disclosure, in their filings. This is now shifted to be disclosure of the material governmental regulations that impact your business. There is a lot of back and forth in that comment letter and the final rules released about, do we have a double materiality here that it's material information about material government regulation? But we can save that for another day.

John Wright:

Yeah. The CEO will love having that conversation with you I'm sure.

Mary Mullany:

So I'd like to use an example from my practice that I think is useful and that's life science companies who might have had some very small reasons to have environmental disclosure but really the impetus for discussing governmental regulation is their process involved in getting regulatory approval or clearance for their products or services. And I think this ties in frankly, nicely to the strategic discussion in the business section where your FDA and EU strategy for pursuing approvals or clearances and where you seek those approvals, where they could be helpful to the company. That disclosure will now be required under these new rules. And in my experience, people

have been doing it for years because that is really material to understanding the company's business and I expect to see that continue.

John Wright:

And at the risk of stating the obvious, this is a reflection of this principles-based orientation of the rules to not finger a particular regulatory scheme but say you tell us what is regulation that's material to your business and how it impacts your business. Would that be a fair statement?

Mary Mullany:

Oh I definitely agree with that. Yap.

John Wright:

So another item that's different is a new item in the list of topics to be considered. At least it's new in the way it's phrased and that's human capital disclosure. This certainly reads like a new and potentially broader discussion than what the old rule contemplated. Can you tell us what is being asked for here?

Naz Jalali:

Sure. The new rules require description of human capital resources, including the number of employees and any human capital measures or objectives that the company focuses on in managing the business and things relating to development, recruitment and retirement of employee, retention of personnel and employees. And the SEC didn't provide any specific metrics, they didn't even define human capital and have left it up to companies to come up with these metrics that are viewed as being material to managing their business. And this is where we are getting a lot of questions and what I think companies are really struggling with on how to start because this is the most significant change. They've been providing this kind of information in other contexts like proxy statements and ESG and sustainability reports. And that's certainly a good place to start.

Naz Jalali:

And one way to also look at it is to look at what a company is presenting or communicating to its board and its committees in terms of metrics or measures relating to its workforce. And although the SEC didn't require or promote or mention any specific human capital reporting framework like Saxby or GRI but these frameworks could serve as a useful tool or resource for companies grappling with, what are the kinds of metrics we should be disclosing now in our 10-K and how much of it should we be including in our 10-K. Those are some things that I'm sure companies are thinking about right now as we're gearing up for 10-K season.

Mary Mullany:

And some of the considerations that go along with these new rules are whatever the disclosure is, should be really material to your business and should not just be a recitation of various policies, for example, that you might have for your employee base or to promote your retention as not as talked about. And one other thing to think about with this though, is once you start down this path and include disclosure, you're making the in essence statement that this disclosure is material to your business. So if it changes pretty dramatically, that could be problematic in subsequent disclosure.

Naz Jalali:

Right. And I think the SEC spoke to that, their expectation is that a company would maintain consistent metrics and if there is a change, highlight those changes. I think the lesson here is to choose your metrics carefully as you develop this disclosure for the first time. And as Mary said, it really is about materiality. So maybe because the audience, for example, in audit for a proxy statement or ESG or sustainability report is different and although those places are a good place to start, it requires, I would expect that maybe the extent and the significance of the disclosures and 10-K will look quite different when it comes to human capital.

Mary Mullany:

And Naz, do you see industry by industry differences here that are going to be possible?

Naz Jalali:

I do. I think it will really vary based on what industry you are in, whether it's a workforce intensive company or industry. For example, retail versus R and D. So I do think there will be some trends or practices or metrics that might be important in one industry but not in others. I do think there will be some variance.

Mary Mullany:

And so I think some of the things people have that could be considered in those industry by industry looks are things like how important is workplace diversity in your company or your industry? Are there gender pay initiatives, hiring policies, health and safety? If you are a manufacturing company or a utility, how important is worker safety or even customer safety for that matter, important to your company? What are the skills and capabilities of your workforce, is this an engineering company with highly skilled workers? And the retention, how important is stability to your business? We do anticipate that a lot of the demographic information will continue to be provided by most or not all companies.

Mary Mullany:

And we do caution that securities act and exchange act liability is now going to attach to human capital disclosure generally, where it perhaps did not in your ESG filings and only applied to your executive disclosure in proxy statements. So Naz, could you talk about some of the open questions that are here in this area because this is a pretty big one?

Naz Jalali:

Sure. What is going to be one of the questions is what is going to be the interplay between the proxy statement disclosure and human capital disclosure that's in your annual reports? I spoke to that a little bit. My thought is that the annual report disclosure is going to be narrower, the proxy statement will serve as a resource but it certainly has a different audience and serves a different purpose than the annual report. And the other question is, there are other concerns about the human capital disclosure, I'm sure companies are thinking about what about competitive information and retention issues in disclosing these metrics? How is that going to impact communications with employees and just internal relationships? So I think those are some of the concerns that companies are grappling with. Mary, do you agree?

Mary Mullany:

I do. And I think we'll be very interested to see how this results in the tank case for next year.

John Wright:

Well, clearly there's a lot to consider in working with these new rules on the business subscription. But let's turn at last to the next two topics that we mentioned. And first talk about the risk factors disclosure that's contemplated by the changes in item 105. What changes did the SEC make to these requirements to disclose risks that a company faces?

Naz Jalali:

The SEC essentially has the most significant change to the risk factors, disclosure that the SEC has now essentially put in place a page limit, if risk factors exceed 15 pages, then you now have to include a concise bulleted and numbered summary of the risk factors at the front of the document. And that summary itself can't be more than two pages. It was intended to serve as a way to discourage lengthy risk factor disclosure, boiler plate and more generic disclosures. And according to the SEC's release, this change would impact about 40% of filers. I will know that offering documents typically already include this type of risk factor summary and so it may not be a significant lift to include such a summary.

Naz Jalali:

And it is a situation where there is some practice in that area that has developed. And I think the one open question is, can a company use a forward-looking statement disclosure to serve as its risk factor summary? And that could certainly be possible, the SEC hasn't provided any guidance on this but as a practice point, it could be a good place to start as long as that that forward looking statement disclaimer, where you were setting out the possibility of different risks that could impact your company that could serve as the summary but it would certainly have to look like a summary in terms of being a bulleted or numbered summary at the front of the document.

Naz Jalali:

I think that would be a good place to start. One of the other changes was that the SEC now requires disclosure of risk factors, not the change of the terminology from most significant factors to material factors, which in my view is not really an impactful change. I think most companies already probably didn't even realize that it says no significant risk factors and just essentially disclosed all of the material risk factors. I don't see that really changing practice much if at all.

John Wright:

So considering these changes, what should companies consider in determining whether to keep their risk factors under the 15 page limit?

Mary Mullany:

I must say this makes me smile. And the SEC has been trying as long as I've been practicing in this area to get people to reduce the generic use of risk factors and really tailor the risk factor disclosure to the company's specific business. And so saying that you're going to count and if you're at 15 pages or over, you need to put more pages in your document to have a summary. Just makes me smile. I don't think frankly, it's going to change practice that much. There are many reasons why people will continue to put what others might consider to be generic risk factors tailored to their company but still in their documents above and beyond the disclosure requirement. I just don't see it making that much of a difference and highly regulated companies are a perfect example. Just about every highly regulated company I work with has risk factors that are more than 15 pages because there's so many material regulations that they need to think about and talk about to protect themselves, frankly.

John Wright:

Well, speaking from the point of view of somebody who is a general counsel and worked on coming up and having conversations about what risk factors should be included and whether they should be tweaked or modified. I'll just say that I join you in that smile.

Naz Jalali:

Couple of other changes that we should probably highlight on the risk factors and which is more style over substance, is that now the SEC has come out and said, you should organize your risk factors under relevant headings and sub captions. But this is something that most companies already do. It's rules catching up with practice. So again, not something that's going to really change practice and the other change is that the SEC also said that to the extent, it's a risk that applies generally to an investment in the company securities. You should list that at the end of the risk factor section under a general risk factors heading and although you're not required to rank or prioritize the risk factors according to the SEC, I think a lot of companies will find that it just makes sense to do that. It's the logical thing to do.

John Wright:

It was certainly the practice in my experience. Finally, let's turn to the changes in the disclosure of legal proceedings. How have the rules relating to the disclosure of legal proceedings been changed by the amendments?

Mary Mullany:

The SEC store keeps the concept of environmental proceedings as being the one area where they absolutely require it but they've also implemented a more hybrid approach to looking at disclosure of legal proceedings where the environmental proceedings dollar amount has been increased from 100,000 to 300,000. And a company can choose a different threshold as long as it stays below a million dollars, depending on the materiality of that to its business. We don't think that that necessarily is going to be all that really changed a lot of the disclosures that are in there.

Naz Jalali:

And the other thing that the SEC sort of made it clear. And again, an example of brutals catching up with practices that a company can cross-reference or hyperlink to legal proceeding disclosures and other parts of the document. And typically that's in the notes to the financial statements and the contingencies notes. And this is so that to avoid repetitiveness because otherwise you're reading the same disclosure multiple times throughout the document.

John Wright:

Okay. So we've noted a number of open issues lurking in the new rules as we've reviewed them. But before we wrap up, are there any other additional open items that we should mention?

Mary Mullany:

Yeah. One of the things I think we've referred to before but didn't really talk about was the form S-3 filings and how they impact right around the effectiveness date of the new rules. So Naz, could you talk a little bit about that?

Naz Jalali:

Yeah. Mary, the question is, if you've got an S-3 in effect before November 9th when the rules become effective, how do you handle that? There's no SEC guidance on these. I think most companies would welcome SEC guidance

on this question but there's no update required before the effective date of the rules because neither item 101, which is a business or a description 103, which is the legal proceedings descriptions are line items of form S-3. So from that standpoint, it's not likely that there would be any updates required for the S-3. The risk factors on the other hand are a line item of form S-3 so I guess the question is whether any of the undertakings obligations the companies make are implicated, if, for example, your risk factors that are incorporated in your 10-K don't comply with the new rules.

Naz Jalali:

For example, there are over 15 pages, and I think most companies will probably come to the conclusion that, it's not a significant or fundamental change that would require updating the S-3. Like I said, I think SEC guidance would be helpful. And if there's an S-3 that's effective after the rules become effective, then you may have to comply with the new rules and make sure that your business disclosures on legal proceedings and risk factors, all that are within the incorporated documents comply with the new rules. I think it again, would be helpful for the SEC to provide some guidance on this.

John Wright:

It sounds as though there's going to be a number of areas where the SEC's views will be helpful going forward and they'll materialize as practitioners come up against the issues. Where can we look to the SEC for guidance?

Mary Mullany:

Certainly on compliance and disclosure interpretations is one place that everyone should look to for areas where the SEC is going to be providing some guidance as we all kind of grapple with these new rules. And we haven't seen a lot there yet but that's a go-to place and certainly blogs and other sources of information for things people think about and will talk about with each other and provide insight into what others are thinking, I think a good place is corporatocounsel.net is certainly one place that has really taken a lead. I would say a bit on this, on way in the future. And I think comment letters may provide information but that's after everybody's done their first disclosure, I don't know how helpful that will be.

John Wright:

Well, this has been a great summary of a lot of changes in these new rules and I hope our listeners get as much out of it as I believe I did. Thank you very much Mary Mullany and Naz Jalali for walking us through these rule changes.

Naz Jalali:

Thank you. Happy to be here.

Mary Mullany:

Thank you, John.

John Wright:

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