

Corporate

SEC Amends Disclosure Requirements for Business, Legal Proceedings, and Risk Factors Sections of Registration Statements and Periodic Filings

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Introduction

On August 26, 2020, the Securities and Exchange Commission, or the Commission, finalized amendments to its rules relating to the disclosure of public companies' description of business, legal proceedings, and risk factors.^[1] The amendments include adding materiality thresholds to certain disclosure requirements and expanding the use of incorporation by reference, which together are intended to improve the quality of disclosures and reduce compliance costs. The amendments also impose new requirements on the presentation of risk factors in response to the growing length of such disclosures.

These updates are the latest from the Commission's review of Regulation S-K pursuant to the JOBS Act and FAST Act. Such legislation tasked the Commission with determining how disclosure requirements can be modernized and simplified.^[2] Even though some of the amendments formalize in Commission rules what has been common practice for many public companies, in total the changes reflect the Commission's continuing move towards principles-based disclosure and away from prescriptive requirements where feasible. The rules are effective 30 days after publication in the Federal Register.

Rules At a Glance	
Item 101: Description of Business	<ul style="list-style-type: none"> • Must disclose information that is material to an understanding of the general development of the business. • Eliminated prescribed timeframes for disclosure. • After a public company's initial filing, the company can provide only material updates to the business since the previous filing. • Information regarding a description of the development of the business in a single prior filing may be incorporated by reference. • Revised disclosure topics to include a description of the company's human capital resources, if material, and disclosure of the effects of all material governmental regulations impacting the business.
Item 103: Legal Proceedings	<ul style="list-style-type: none"> • The disclosure threshold for certain environmental proceedings is increased to an amount between \$300,000 and \$1,000,000, depending on the assets of the public company. • Information may be incorporated by reference.
Item 105: Risk Factors	<ul style="list-style-type: none"> • Must disclose "material" risk factors rather than the "most important" risk factors. • A summary risk factor disclosure section is required if the risk factor section exceeds 15 pages. • Risk factors are to be organized under relevant headings.

Description of Business

General Development of Business

Current Disclosure Requirements

Item 101(a) of Regulation S-K currently requires public companies to describe the general development of their business. The rule also requires public companies to disclose their year and form of organization and, to the extent applicable, any bankruptcy, material corporate transaction, or other material change in the mode of conducting business. The disclosure generally covers the prior three years for Smaller Reporting Companies and five years for all other public companies, unless the public company has been in business for fewer years.

Revised Item 101(a) of Regulation S-K

Amended Item 101(a) of Regulation S-K will instead rely entirely on a materiality threshold, whereby public companies are required to disclose information material to an understanding of the general development of the business. The Commission also eliminated the prescribed five and three year look-back periods. Public companies will need to disclose material business information regardless of the timeframe it occurs and may elect to disclose longer periods or shorter periods to the extent that it helps investors understand their business.

In connection with the materiality standard, the Commission elected to revise the list of disclosure topics in Item 101(a) regarding the development of the business. The Commission specifically adopted four, non-exclusive disclosure topics that public companies should consider in their analysis:

- Any material changes to a previously disclosed business strategy;
- The nature and effects of any material bankruptcy, receivership, or any similar proceeding with respect to the public company or any of its significant subsidiaries;
- The nature and effects of any material reclassification, merger or consolidation of the public company or any of its significant subsidiaries; and
- The acquisition or disposition of any material amount of assets otherwise than in the ordinary course of business.

Most notably, the list above now includes “any material changes to a previously disclosed business strategy” to highlight the importance of keeping public information about the direction of the business fresh. The Commission elected to not require public companies to disclose their business strategy in general and the amended rule does not take a stance on whether disclosing a public company’s business strategy is “material to an understanding of the general development of the business.” Other updates to the list include removing material changes that impact the public company’s operations—as this is already covered by Item 303 (Management’s Discussion & Analysis)—and removing the public company’s date and form of organization from the disclosure topics.

To further streamline Item 101 disclosure, the Commission amended Item 101(a) and 101(h) to allow, but not require, public companies to reference a previously-filed general description of the public company’s business in a report or registration statement and then provide any applicable updates for the reporting period. The general description of the business must be contained in one filing and hyperlinked into the filing containing the update. Functionally, this acts similar to a “bring down” of updates since the original filing. Importantly, the Commission did not make the “incorporate and update” rules mandatory. Companies may still describe the general development of their business in one filing.

Narrative Description of Business

Current Disclosure Requirements

Item 101(c) of Regulation S-K requires public companies to provide a narrative description of their business, with a focus on the public company’s dominant segment or each reportable segment. The rule also enumerates twelve disclosure topics, any of which must be discussed if such information is material to understanding the public company’s business as a whole. Often companies disclosed many

of the twelve disclosure topics, even if not necessarily material to their business.

Revised Item 101(c) of Regulation S-K

The final amendments to Item 101(c) of Regulation S-K clarify that the general import of the rule is to only disclose information about the business done or intended to be done that is material to an understanding of the business as a whole. The disclosure topics listed in Item 101(c) of Regulation S-K are presented as simply examples, meaning public companies should consider any other facts or circumstances that are material to the company.

The amended rule also includes a revised list of disclosure topics. The Commission largely reorganized the current list and generalized topics by removing references to specific dollar or percentage thresholds. But of particular importance, the amended rule newly prompts public companies to consider whether a description of their human capital resources generally, and not just the number of persons employed by the public companies specifically, is material to disclose. For example, public companies should consider whether a discussion of their measures or objectives to address the development, attraction, and retention of personnel is appropriate to disclose. This addition reflects the Commission's view that human capital—however defined by a public company—can be a material resource that is important for investors to consider when making investment and voting decisions.

In addition to the human capital disclosure, the Commission expanded the requirement to disclose material effects of compliance with environmental laws to instead require disclosure of the material effects that compliance with government regulations, including environmental regulations, may have upon the capital expenditures, earnings, and competitive position of the public company and its subsidiaries.

Legal Proceedings

Current Disclosure Requirements

Pursuant to Item 103 of Regulation S-K, public companies are required to disclose material pending legal proceedings to which they or their property are party to. There is a further requirement to disclose any proceedings under environmental law to which a governmental authority is a party if the company reasonably believes the proceeding will result in sanctions of at least \$100,000. Notwithstanding Item 103, public companies regularly disclose legal proceedings and similar contingency information elsewhere in their periodic filings, most often in the Management's Discussion & Analysis and in the contingencies footnote to the financial statements. In revising the rules, the Commission sought to eliminate duplicate disclosure and increase the dollar limit for the environmental disclosure.

Revised Item 103 of Regulation S-K

To accomplish these goals, the Commission amended Item 103 to effect two changes to the legal proceedings section:

1. **Companies Can Incorporate By Reference Other Disclosure Meeting this Requirement:** To reduce duplicate disclosure, amended Item 103 will expressly permit public companies to incorporate these separate discussions by cross-reference or hyperlink. This matches the practice that many companies already follow currently.
2. **Dollar Threshold Increased for Environmental Disclosures:** Amended Item 103 also increases the dollar threshold that applies to the disclosure of certain environmental proceedings. The threshold of \$100,000 has been used since 1982, so the Commission originally proposed to increase it to \$300,000 for inflation. The final amendments adopted \$300,000 as the default threshold, but now public companies may elect to use a higher threshold as long as it is "reasonably designed to result in disclosure of any [applicable environmental] proceeding that is material to its business or financial condition." Such threshold may not exceed the lesser of \$1,000,000 or one percent of the public company's assets on a consolidated basis, and public companies must disclose the threshold and any changes thereto in each periodic report.

Risk Factors

Current Disclosure Requirements

Currently Item 105 of Regulation S-K requires public companies to disclose the most significant factors that make an investment in the public or offering speculative or risky, commonly known as risk factors. The risk factor disclosure must be concise and not include risks that could apply generically to any public company or offering. Despite the language of the current rule, according to research cited by the Commission, risk factors sections have considerably grown in length over time^[3] and based on the observations of the Commission, many companies' risk factors contained generic risks that were applicable to any company or offering.^[4] The Commission also recently updated Item 105 to remove some example risk factor coverage and these changes are a continuation of that effort.^[5]

Revised Item 105 of Regulation S-K

As a result, the amended Item 105 rules adopted three significant changes to the risk factors section:

1. **“Material” Risk Factors Must be Disclosed**: Item 105 will now require disclosure of “material” risk factors (rather than the most significant), thereby urging public companies to focus on those which reasonable investors would attach importance to in making an investment or voting decision. The materiality threshold may also curb the inclusion of generic risk factors that investors take as a given.
2. **Disclosures Longer Than 15 Pages Requires a Summary Section**: Amended Item 105 also addresses the issue of the length of the risk factors section. Going forward, public companies will be required to include a summary risk factor disclosure in the forepart of the document if the risk factor section exceeds fifteen pages. This disclosure should include concise, bulleted or numbered statements summarizing the principal risk factors and cannot run longer than two pages.^[6]
3. **Risk Factors Must be Organized Under Headings**: And lastly, the amended Item 105 will require public companies to organize risk factors under relevant headings, with all generic risk factors grouped under a heading titled “General Risk Factors.” While some companies elect to organize risk factors under certain headings such as “Risks Related to Our Indebtedness,” “Risks Related to Our Common Stock,” and “Risks Related to Our Business,” we believe that market practices will sharpen the headings over time based on the applicable company and their industry.

Considerations for Foreign Private Issuers

Certain issuers located outside of the United States, referred to as “foreign private issuers,” are subject to an alternative set of disclosure requirements. A foreign private issuer is defined as any foreign issuer other than a foreign government, except for an issuer that (1) has more than 50% of its outstanding voting securities held of record by US residents; and (2) any of the following: (i) a majority of its officers and directors are citizens or residents of the United States; (ii) more than 50% of its assets are located in the United States; or (iii) its business is principally administered in the United States.^[7]

The final amendments to Items 101 and 103 discussed above will impact only domestic registrants and foreign private issuers that have elected to file on domestic forms subject to Regulation S-K disclosure requirements. Foreign private issuers are not required to abide by Regulation S-K unless a form reserved for foreign private issuers (such as Securities Act Form F-1, F-3, or F-4) specifically refers to Regulation S-K. Otherwise, forms commonly relied upon by foreign private issuers refer to Part I, Item 4 and Item 8.A.7. of Form 20-F instead of Items 101 and 103 of Regulation S-K, respectively.

In contrast, the final amendments to Item 105 discussed above will impact both domestic and foreign registrants because each of Form F-1, F-3, and F-4, like their domestic counterparts, refer to that Item.

Compliance Date

The final rules are effective 30 days after the date of publication in the Federal Register.

[1] Securities and Exchange Commission Modernization of Regulation S-K Items 101, 103, and 105, (August 26, 2020) available at <https://www.sec.gov/rules/final/2020/33-10825.pdf> (the “Adopting Release”).

[2] Previously the Commission adopted amendments to the Regulation S-K rules governing Management’s Discussion & Analysis, confidential information, and the description of property, and additional changes to Management’s Discussion & Analysis are in the proposed rulemaking stage.

[3] Adopting Release at 65–66.

[4] *Id.* at 66.

[5] Securities and Exchange Commission, FAST Act Modernization and Simplification of Regulation S-K (March 20, 2019) available at <https://www.sec.gov/rules/final/2019/33-10618.pdf>.

[6] The Commission estimates about 40% of filers will need to include a summary disclosure unless they elect to edit their current disclosure. See Adopting Release at 71.

[7] See 17 CFR § 230.405; 17 CFR § 240.3b-4(c).



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