



Securities Quarterly Update

October 2020

Welcome to the fall issue of Securities Quarterly Update, a publication that provides updates and guidance on securities regulatory and compliance issues. In this edition, we look at several recent amendments to disclosure rules announced by the SEC, ongoing disclosure developments related to COVID-19, as well as other general updates in securities laws and regulations that public companies should consider as they prepare their Form 10-Q filings for the third quarter of 2020.

SEC Rule Amendments to Business Description, Legal Proceedings and Risk Factor Disclosures Under Regulation S-K

On August 26, the SEC adopted a [Final Rule to amend and modernize certain disclosure requirements under Regulation S-K](#) applicable to the description of business (Item 101), legal proceedings (Item 103) and risk factors (Item 105), marking the first significant revision to public company business disclosure rules in over 30 years. Although the description of business in accordance with Item 101 is not required in quarterly reports on Forms 10-Q, companies should consider in advance whether any changes will be necessary to their annual reports on Forms 10-K, particularly to the sections relating to the companies' business strategy, human capital and government regulation disclosures. The amendments become effective on November 9, 2020 and will apply to many quarterly reports for the third quarter. However, even if the company's Form 10-Q is filed before the effective date, the company may want to comply with the amended requirements, particularly if its risk factors are restated in full in its Form 10-Q. The amendments are summarized in more detail below:

General Development of Business (Item 101(a))

Item 101(a) was modified to make the business description disclosure "principles-based," meaning disclosure of

information material to an understanding of the general development of the company's business.

The amendments also eliminate the requirement that the discussion cover the past five years, or three years with respect to smaller reporting companies under Item 101(h); rather, disclosure will follow a materiality standard based on what is relevant and material to an understanding of the general development of the company's business. In addition, the amendments now permit companies to provide only an update containing material developments since the initial or more recent filing. When providing an update disclosure, companies are required to incorporate the most recent full discussion of the general development of their business and include a hyperlink to the filing. Unique to this requirement, the reference is required to be to a single prior filing as opposed to referencing multiple sources of the full disclosure. Companies remain free to provide a full discussion of the general development of their business instead of an update.

The amendments also replace the prior list of prescribed topics with a non-exclusive list of potentially material disclosure items. The list includes three topics presently covered: (1) disclosure of material bankruptcy proceedings; (2) disclosure of the effects of any material merger or consolidation of the company; and (3) disclosure of the acquisition or disposition of any material amount of assets. This list adds a new topic requiring disclosure of material changes to the company's previously disclosed business

strategy; therefore, companies that have previously included a description of their business strategy, in connection with a recent IPO or otherwise, are now required to update such disclosure if changes would be material to understanding the company's business.

Narrative Description of Business (Item 101(c))

Prior to these amendments, Item 101(c) contained 12 specific topics, and many companies discussed all of them. The "principles-based" approach is intended to provide companies with "flexibility to tailor disclosures to their unique circumstances," thereby only requiring disclosure if the information is material to an understanding of the company's business. The amendments focus on a non-exclusive list of topics derived from the prior topics that includes: (1) revenue-generating activities and dependence on certain products, services or customers; (2) development efforts for new or enhanced products, trends in demand and competitive conditions; (3) sources and availability of resources material to a company's business, including raw materials and certain intellectual property rights; (4) business subject to renegotiation or termination of government contracts; (5) seasonality of the business; and (6) the number of persons employed.

In addition, as one of the more significant developments, the amendments add a requirement to describe human capital resources to the extent such disclosures are material to understanding the business. This includes human capital measures or objectives used in managing the company's business (e.g., those addressing the development, attraction and retention of personnel). Human capital disclosures should be tailored to the particular company and its industry. It is worthwhile to start reviewing potentially applicable measures and begin drafting human capital disclosures early on. These disclosures are likely to face great scrutiny from both investors and employees, and companies should ensure that data is being appropriately collected, the company avoids "greenwashing" in SEC filings, and any human capital measures that are selected are being measured in a consistent manner over time, are fact-checked and incorporated into the company's disclosure controls and procedures, and are also incorporated into the board's risk oversight process. Our

Public Companies team is working on these disclosures with many companies, and we are here to help if you need us.

Legal Proceedings (Item 103)

The Item 103 disclosure of material legal proceedings was modified to expressly permit incorporation of required information by reference from another section, either by a hyperlink or a cross-reference. Although many companies already include cross-references and it is expected that a number of companies will add hyperlinks, one caveat is to remain cognizant of different disclosure requirements for "contingencies" discussed in the notes to the financial statements and "legal proceedings." In addition, the amendments increase the disclosure threshold for certain governmental environmental proceedings resulting in monetary sanctions from \$100,000 to (1) \$300,000 or, if a company reasonably determines that a higher threshold is appropriate, (2) a higher threshold not to exceed the lesser of \$1 million or 1% of its current assets, in which case the use of such threshold is required to be disclosed in each Form 10-Q and Form 10-K. It is a welcome development for many companies that from time to time were faced with describing environmental proceedings immaterial to the company in SEC filings.

Risk Factors (Item 105)

In an effort to reduce "boilerplate" risk factor disclosures, Item 105 was amended to: (1) require summary risk factor disclosure of no more than two pages if the risk factor section exceeds 15 pages; (2) replace the requirement to disclose the "most significant" risk factors with "material" risk factors in an effort to focus companies on describing risks to which investors would attach importance in making investment or voting decisions; (3) require that risk factors be organized under relevant headings; and (4) if stating broadly applicable risk factors, require companies to include those at the end under the heading "General Risk Factors." Given liability considerations in risk factor disclosures, it is unclear whether these amendments will lead to less lengthy disclosures.

Companies that include risk factors in full in their quarterly reports on Forms 10-Q should review this section to see if a summary or any reorganization of risk factors is necessary,

and those that do not may want to begin review of the risk factors for their Forms 10-K somewhat earlier this year.

SEC Amendments to “Accredited Investor” and “Qualified Institutional Buyer” Definitions

On August 26, the SEC [announced amendments to the “accredited investor” and “qualified institutional buyer” definitions](#) to expand the criteria for qualifying as an “accredited investor” in Rule 501(a) of the Securities Act by including:

1. individuals
 - a. who hold certain professional credentials, and
 - b. who are “knowledgeable employees” of certain funds exempt from the Investment Company Act of 1940 (40 Act);
2. limited liability companies with \$5 million in assets;
3. a new category for entities owning certain investments in excess of \$5 million and not formed for investing in the securities offered;
4. SEC-registered and state-registered investment advisers, exempt reporting advisers, and rural business investment companies;
5. “family offices” with at least \$5 million in assets under management and their “family clients,” as defined under the 40 Act; and
6. “spousal equivalents” for pooling of finances.

The amendments also expand the definition of “qualified institutional buyer” in Rule 144A of the Securities Act to include: (1) limited liability companies; (2) rural business investment companies; and (3) institutional investors included in the accredited investor definition that are not otherwise enumerated, provided in each case that they meet the \$100 million in securities owned and invested threshold.

Expanded Disclosure for Banking Registrants

On September 11, the SEC [announced rules to expand the statistical disclosures applicable to bank holding companies, banks, savings and loan holding companies, and savings and loan associations](#) to include (1) distribution of assets, liabilities and stockholders’ equity, the related interest income and expense, and interest rates and interest differential; (2) weighted average yield of investments in

debt securities by maturity; (3) maturity analysis of the loan portfolio; (4) certain credit ratios and the factors that explain material changes, during the periods presented; (5) allowance for credit losses by loan category; and (6) bank deposits including average amounts and rate paid and amounts that are uninsured. The new rules replace Industry Guide 3 applicable to banking companies and will apply to fiscal years ending on or after December 15, 2021, with earlier voluntary compliance accepted.

OTC Companies to Provide Greater Disclosure

On September 16, the SEC adopted amendments to Exchange Act Rule 15c2-11 containing requirements for brokers to comply with before they publish quotations for securities in the over-the-counter market. The changes are significant to OTC-quoted companies that do not provide “current public information” as trading may be impaired. For a more detailed discussion, see our [Securities Update dated September 18, 2020](#).

COVID-19 Disclosure Considerations

In our [July 2020 edition of the Securities Quarterly Update](#), we reviewed COVID-19-related disclosure considerations for Forms 10-Q. What may have once been considered short-term impacts of COVID-19 may now reflect permanent costs of doing business, and given the continuing effects of COVID-19 on companies and markets, most or all of these considerations still apply and should again be considered while companies prepare their next Form 10-Q or 10-K. Applicable management discussion and analysis (MD&A) and “subsequent event” disclosures in the notes to the financial statements should again be reviewed and updated to reflect the company’s current circumstances, remaining alert for any new trends and developments, whether positive or negative, including, for example, the impact of business reopenings. Companies that added risk factors in their last Forms 10-Q, related to COVID-19 or otherwise, should revisit and update those as necessary, and those that did not should consider once again if inclusion is necessary now.

In addition, any material changes to internal controls (e.g., relating to changes from working from home) made during the quarter should be disclosed in the Form 10-Q. Further,

companies that use non-generally accepted accounting principles (GAAP) financial measures in SEC filings or earnings releases and include COVID-19-related adjustments should revisit whether such adjustments are still appropriate or whether any of such costs would now be viewed as part of the “new normal.” The SEC’s focus on non-GAAP financial measures and key performance indicators continues, as demonstrated by recent SEC comment letters and enforcement actions.

Expiring Confidential Treatment Orders

On September 9, the SEC Division of Corporation Finance updated [CF Disclosure Guidance: Topic No. 7](#) to [issue guidance](#) on how companies may respond to expiring confidential treatment orders, specifically, by: (1) refiling the unredacted exhibit; (2) extending the confidential period pursuant to Securities Act Rule 406 or Exchange Act Rule 24b-2; or (3) transitioning to compliance with the redacted exhibit rules under Regulation S-K Item 601(b)(10), and other parallel rules.

FOR MORE INFORMATION

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