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SEC Adopts Final Disclosure Update and Simplification Amendments

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On August 17, the SEC adopted final amendments relating to an ambitious housekeeping effort, "Disclosure Update and Simplification," a component of the SEC's disclosure effectiveness project. The final amendments address certain disclosure requirements that have become redundant, duplicative, overlapping, outdated or superseded, in light of other SEC disclosure requirements, US GAAP or "changes in the information environment." This "demonstration version" of the final amendments provides a blacklined version displaying the changes. The final rules become effective 30 days after publication in the *Federal Register*, and the staff has indicated that it will review the impact of the amendments within five years thereafter.

The final amendments eliminate entirely a number of provisions that are completely duplicative, as well as a variety of references to obsolete terms such as "pooling-of-interests accounting" and "extraordinary items." In another nod to modernity, the SEC removed the requirement to identify the SEC's Public Reference Room and disclose its physical location and phone number; instead, the SEC will retain the requirement to disclose the SEC's internet address and require all issuers to disclose their internet addresses if they have one. SEC disclosure requirements that overlap with GAAP, IFRS or other SEC disclosure requirements have, in some instances, been deleted and, in other instances, where the requirement involved incremental material information, been integrated into other requirements. In some cases where the disclosure requirements overlap with GAAP but require material incremental information, the SEC retained the requirement, but referred the items to FASB for potential incorporation into GAAP in the future.

For the most part, the changes are not particularly earth-shaking. However, where the amendments result in relocation of disclosure *into the financial statements*, the effect can be burdensome in that it subjects the new disclosure to audit or interim review and audit of internal control over financial reporting, which could create potential verification and auditability issues. In addition, XBRL tagging requirements apply to information in the financial statements. Moreover, because the safe harbor for forward-looking information under the Private Securities Litigation Reform Act of 1995 does not apply to financial statements, potential liability concerns are introduced. In this regard, relocation of disclosure into the financial statements, together with the absence of the PSLRA safe harbor protection, may make issuers more wary about supplementing required disclosures in the financial statements with forward-looking information. However, the SEC noted that it did not adopt any *requirements* to disclose forward-looking information in the financial statements and further observed that issuers retain the option of providing forward-looking information outside of the financial statements (and, in some cases, are required to provide that information). Of course, relocating disclosures *outside the financial statements* will have the opposite effect, no longer subjecting the information to requirements for audit, review or XBRL, and providing the potential for PSLRA protection. Other changes may simply affect the relative prominence of the disclosure or impose or remove a bright-line disclosure threshold.

Some notable changes

To convey the flavor of the changes, below are selected changes affecting Regulation S-K. Note, however, that many of the changes effected by the amendments relate to Regulation S-X and the financial statements.

Item 101 – Description of Business

Segments and geographic information. In light of existing GAAP and Item 303(b) disclosure requirements, the amendments eliminate the mandates in Item 101 to provide segment financial information and financial information by geographic area. The current rule explicitly permits issuers to avoid duplication by cross-referencing to the applicable notes to the financial statements, and that is how most companies have historically addressed this requirement. Now, companies will not have to bother with that cross-reference.

Foreign operations. Similarly, the SEC eliminated the requirements to disclose under Item 101 material risks

associated with an issuer's foreign operations and any segment's dependence on foreign operations. Those matters, the SEC concluded, are more appropriately disclosed under "Risk Factors" and, where appropriate, in MD&A. To make that point explicit, the SEC has added a specific reference to "geographic areas" to the MD&A requirement to disclose trends and uncertainties by segment.

R&D. Similarly, because the information is comparable to information already required by GAAP, the SEC has eliminated the mandate to disclose under Item 101 the amount spent on R&D activities for all years presented.

Major customers; product revenue. However, the SEC elected to retain some of the overlapping provisions that require disclosure of information incremental to GAAP and to instead refer them to FASB for potential incorporation into GAAP. For example, both GAAP and Item 101 require disclosures about major customers: Regulation S-K requires disclosure if loss of one or a few customers would have a material adverse effect on a segment, while GAAP requires certain disclosures for each customer that accounts for 10% or more of total revenue. In addition, Regulation S-K requires disclosure of the name of any customer that represents 10% percent or more of revenues and the loss of which would have a material adverse effect, while GAAP does not. Similarly, both GAAP and Regulation S-K require disclosure regarding revenue from products and services; however, the Regulation S-K mandate has a 10% threshold, while GAAP requires disclosure for each product or service, or group of similar products and services, unless impracticable. Depending on FASB's decision regarding integration of this information into the applicable GAAP requirement, modifications could result in PSLRA safe harbor and other financial statement disclosure issues, as well as issues arising out of the elimination or inclusion of bright-line disclosure thresholds.

Item 201 – Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters

Market prices. The SEC has updated the market price disclosure requirements: instead of requiring disclosure of the high and low sales prices and sales price as of the latest practicable date – which are readily available for free on numerous websites on a daily basis and likely more up to date – Item 201(a)(1) is being amended to eliminate the detailed disclosure requirement to provide sale or bid prices for most issuers with common equity traded in an established public trading market and replaced with disclosure of the trading symbol. More specifically:

- Issuers with one or more classes of common equity will be required to identify the principal US markets where each class is traded and the corresponding trading symbols used by the markets for each class of common equity. Foreign issuers will also be required to identify the principal foreign public trading markets, if any, and the trading symbols, for each class of their common equity.
- Issuers with common equity that is not traded on an exchange will be required to indicate, as applicable, that any over-the-counter market quotations in these trading systems reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.
- Issuers with no class of common equity traded in an established public trading market will be required to state that fact and disclose the range of high and low bid information, if applicable, for each full quarter within the last two fiscal years and any subsequent interim period. In addition, these issuers must disclose the source and explain the nature of the quotations.

Dividends. The amendments also streamline the various redundant and overlapping requirements in Regulations S-X and S-K to discuss dividends. The SEC is eliminating the requirement in Item 201 to disclose restrictions that currently or are likely to materially limit the company's ability to pay dividends on its common equity; instead, companies will be required to provide disclosure of material restrictions on dividends only in the notes to the financial statements under Regulation S-X. Likewise, the amendments eliminate the requirement in Item 201 to disclose the frequency and amount of cash dividends declared for the two most recent fiscal years and any subsequent interim period; rather, the amendments will mandate that Rule 3-04 of Regulation S-X, which currently requires financial statement disclosure of the amount of dividends per share and in the aggregate, be applied to interim periods.

Convertible/exercisable securities. In light of the broader GAAP requirement to disclose the terms of significant contracts to issue additional shares and other reasonably similar information, the SEC has eliminated the Item 201 requirement to disclose on Form S-1 or Form 10 the amount of common equity subject to outstanding options, warrants or convertible securities, when the class of common equity has no established US public trading market.

Equity compensation plan table. Another overlapping provision that was proposed to be eliminated is instead

being retained and referred to FASB for potential incorporation into GAAP: the SEC decided not to eliminate the mandate in Item 201(d) to provide tabular disclosure regarding existing equity compensation plans approved and not approved by shareholders. This information is currently required in a number of different forms, including Forms 10-K and proxy statements. In the proposal, the SEC had suggested elimination of the provision because it overlapped with a similar GAAP requirement and because the SEC believed that drawing the distinction between plans approved and not approved by shareholders was no longer useful to investors because the major exchanges now require, with limited exceptions, plan approvals by shareholders. However, relocating the disclosure to the financial statement notes would raise potential liability issues in the absence of PSLRA protection and would mean that the disclosure would no longer appear alongside information about equity compensation plans subject to shareholder action. At the end of the day, the SEC decided to retain and refer to FASB the overlapping requirement, recognizing the concerns expressed by commenters that GAAP does not explicitly require certain information that could be material to investors, such as the formula for calculating the number of securities available for issuance under the applicable plan. Note, however, that, while the final rules currently retain Item 201(d), referring it to FASB, they surprisingly still *eliminate* the provisions in Schedule 14A (proxy statements) and Form 10-K that currently mandate the inclusion of Item 201(d) disclosure in those documents. As a result, although item 201(d) disclosure would continue to be required in Form S-1 and Form 10, unless the staff indicates otherwise, under the new amendments, Item 201(d) disclosure would not be required in proxy statements or Forms 10-K. In informal discussions with the staff, we have been advised that the staff is aware of the issue and is considering it.

Item 303 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Seasonality. The amendments eliminate Instruction 5 to Item 303(b) regarding seasonality because it required disclosures that convey reasonably similar information to that required under GAAP and the remainder of Item 303.

Item 503 – Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges

Ratio of earnings to fixed charges. The amendments eliminate the requirement in Item 503(d) to disclose the historical and pro forma ratio of earnings to fixed charges (and ratio of combined fixed charges and preference dividends to earnings) in connection with the registration of debt securities and preference equity securities. The SEC observed that now a "variety of analytical tools are available to investors that may accomplish a similar objective as the ratio of earnings to fixed charges." In addition, the SEC noted, debt investors often negotiate covenants requiring issuers to provide more relevant financial information.

Item 601 – Exhibits

Earnings per share. The final amendments eliminate Item 601(b)(11), which requires a statement showing the calculation of per-share earnings (unless the computation can be determined from information already in the report) in annual filings. According to the SEC, that requirement is duplicative of information required under GAAP, Regulation S-X and IFRS.

Ratio of earnings to fixed charges. In connection the elimination of Item 503(d), the related Item 601(b)(12) exhibit filing requirement has been eliminated.

Reports to shareholders. Various reports to security holders, required to be filed as exhibits under Items 601(b)(19) and (22), are also eliminated in light of, in the former case, other exhibit provisions or, in the latter case, the requirement to disclose shareholder voting results in a Form 8- K.

On the horizon

With regard to those incremental disclosure requirements that were referred to FASB for consideration of whether they should be incorporated into GAAP, the SEC requested that FASB determine whether to add these items to its agenda within 18 months after publication of the adopting release in the *Federal Register*. In a statement to *Bloomberg BNA*, FASB indicated that it was "reviewing the SEC's recommendations, and that board members will discuss the request at an upcoming public meeting." Accordingly, depending on the position ultimately taken by FASB, financial reporting requirements could become more burdensome for all companies – and especially for smaller reporting companies – if FASB determines to incorporate these incremental disclosures into GAAP.

In addition, the SEC indicated that it planned to continue to study the question of the potential integration of the mandate under GAAP to disclose loss contingencies and the requirement under Item 103 of Regulation S-K to disclose certain legal proceedings, which are one type of loss contingency. Item 103 includes a bright line disclosure threshold in some cases of 10% of the issuer's consolidated current assets, while GAAP provides a more general materiality threshold. However, the overlap has historically led many companies to either repeat the disclosures or cross-reference to them. In the proposing release, the SEC had considered referring the issue to FASB for potential incorporation into GAAP. As described by the SEC in the proposing release, incorporation of Item 103 requirements into GAAP would result in more instances of disclosure of the possible range of loss, more disclosure that is subject to audit or review, internal control and XBRL requirements, more disclosure of prescribed facts (such as the court or agency, the date instituted, the principal parties involved, the alleged factual basis of the proceeding and the relief sought) and a more general materiality threshold in connection with environmental legal proceedings (instead of the bright-line thresholds in Regulation S-K). It would also give rise to PSLRA safe harbor protection issues and other financial statement concerns. The SEC observed in the adopting release that many commenters opposed the integration on a variety of bases, including the possible need to revisit the ABA policy statement regarding lawyers' responses to auditors' requests for information. Some commenters supported the integration, noting the repetition in many filings, and some recommended that the SEC conduct more analysis and outreach. Ultimately, the SEC apparently took that advice and determined to retain the current requirements and study the issue further.

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