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Securities Regulation & Law Report™

DISCLOSURE

SEC Staff Report Recommends New Comprehensive Review To Amend Regulation S-K

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Introduction

On Dec. 20, 2013, the staff of the Securities and Exchange Commission Division of Corporation Finance issued a report reviewing the disclosure requirements of Regulation S-K to determine how they can be updated to modernize and simplify the SEC registration process.[1] The staff's review was mandated by Section 108 of the Jumpstart Our Business Startups Act (JOBS Act), which was passed by Congress in April 2012. The report suggests areas where changes would be merited, but only after further study, information gathering and input from companies, investors and other market participants. The report nonetheless reflects the current direction being taken by the staff with regard to disclosure in public filings. With expectations for increased equity capital markets activity in 2014, this article is intended to give notice to prospective issuers and underwriters of likely disclosure changes and potential ''hot topics'' to be looked at by the SEC in the coming year.

Since the staff's report was mandated by the JOBS Act, the original intent was for it to be prepared from the perspective of easing the path to going public for emerging growth companies (EGCs) and other smaller publicly-traded companies. The staff observed, however, that the disclosure requirements in Regulation S-K also have an impact on the ongoing compliance costs and other burdens of publicly-reporting companies and, as a result, a comprehensive (as compared to targeted by item) review of all requirements of Regulation S-K would benefit all companies at every stage in their development. The staff concluded that any ''simplifications, modernizations, revisions or eliminations'' should be made for all public companies.

The report does not provide for any formal public comment process. Like no-action letters and staff legal bulletins, the staff's analysis, findings and conclusions do not necessarily represent the views of the entire SEC.

History and Trends in Disclosure Rules

As a preliminary matter, the staff's report reviewed the origins and purposes of existing disclosure items in

[1] U.S. SEC. & EXCH. COMM'N, REPORT ON REVIEW OF DISCLOSURE REQUIREMENTS IN REGULATION S-K (2013), *available at* http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf

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 ISSN 0037-0665

Regulation S-K and the history of significant substantive amendments to those requirements over the past 50 years, from simplified reporting for small issuers through guidance on the use of electronic media. Even with periodic piecemeal updates, the staff indicated that no comprehensive review of the SEC's disclosure requirements has been conducted in almost 20 years. During that time, the staff noted that significant technological advances have significantly changed the ways that businesses operate and communicate with investors, coupled with dramatic events such as the rise and collapse of the technology sector in 2000, the collapse of Enron Corp., the enactment of the Sarbanes-Oxley Act, the financial crisis of 2008, the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the enactment of the JOBS Act. The staff concluded that the SEC's disclosure requirements should be reevaluated to ensure that existing security holders, potential investors and the marketplace are provided with meaningful and non-duplicative information upon which to base investment and voting decisions.

The staff's observations on possible Regulation S-K changes also include public comments submitted to the SEC's JOBS Act website[2] and recommendations from the SEC's Government-Business Forum on Small Business Capital Formation.[3] These comments and recommendations will be considered in the SEC's final disclosure amendments, many of which are noted below along with the staff's list of potential areas for rule changes.

Recommended Areas of Focus for Rule Changes

The staff identified the following general areas of Regulation S-K that merit further review.

Consolidation of Risk Factors and Legal Proceedings. The staff posed for consideration the consolidation of requirements relating to risk factors, legal proceedings and other quantitative and qualitative information about risk and risk management into a single requirement, as well as the appropriateness of the disclosure requirements for quantitative and qualitative market risk in Item 305 of Regulation S-K. Comments submitted to the SEC's JOBS Act website suggested that EGCs, like smaller reporting companies, should be exempt from Item 305 disclosure on quantitative and qualitative disclosures about market risk. Commenters noted that EGCs are unlikely to have significant cash balances or outstanding borrowings so that they would be subject to interest rate risk that is material to the company, they generally do not engage in hedging activities or commodity trading and do not trade in foreign currencies but rather tend to complete offshore sales in U.S. dollars.

As to legal proceedings, a commenter recommended that the current exemption for disclosure of legal proceedings involving claims of less than 10 percent of the registrant's consolidated current assets under Item 103 should be reconsidered because, for some companies, the amount of current assets is not as relevant as total company value or liquidity.

Business and Operations Disclosure. The staff questioned whether information required by Items 101 and 102 of Regulation S-K about principal properties, mines and plants (which includes a list of locations, capacity and ownership) continues to be relevant when so many tech-based businesses do not require physical locations to operate, can easily substitute physical locations without any material impact on their operations or where physical plant and properties are not a significant element of enterprise value. For these companies, disclosure requirements could be refocused on material facts about their properties and their significance to the overall business.

The staff also identified a potential disclosure gap dealing with tech-based businesses. The staff is considering the need for additional disclosure where a business relies heavily on intellectual property owned by a third party or relies on service agreements with third parties to perform its business functions. Likewise, in comments submitted to the SEC's JOBS Act website, commenters questioned whether the requirement to disclose the amount of backlog orders believed to be firm should be eliminated since it is not particularly meaningful to non-industrial, tech-based businesses, or, alternatively, those requirements should be moved to Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) with industry-specific disclosure.

On MD&A, recommendations were submitted to the SEC's JOBS Act website for updating two MD&A requirements. First, they recommended eliminating or reducing disclosure in MD&A relating to a company's historical practice for establishing the fair value of the company's common stock in connection with stock-based compensation. Second, it was recommended that repetition of previous year-to-year analysis of results of operations should be eliminated in annual reports on Form 10-K.

Finally, the staff raised the potential for calibrating business disclosure for different types of investors, presumably based on whether the offering would be intended primarily for retail or institutional investors.

Offering Statements. The staff suggested reevaluation of the requirements for the presentation of information in prospectuses, required legends and undertakings in light of the shift from paper-based offering documents to electronically-delivered offering materials. Similarly, requirements concerning underwriting arrangements and compensation should be updated to reflect evolving changes in market practices.

The staff also pointed to combining information about dilution, shares eligible for future sale and securities authorized for issuance under equity plans and under outstanding derivative securities and agreements. Some commenters on the SEC's JOBS Act website suggested, instead, to exempt EGCs from the Item 506 dilution disclosure requirements in IPO registration statements, asserting that such disclosure is relatively meaningless in the context of EGCs because they rarely have an amount of net tangible book value per share that even approaches the level of the initial public offering price.

[2] *Public Comments on SEC Regulatory Initiatives Under the JOBS Act*, U.S. SEC. & EXCH. COMM'N, *available at* http://www.sec.gov/spotlight/jobsactcomments.shtml

[3] *Government-Business Forum on Small Business Capital Formation*, U.S. SEC. & EXCH. COMM'N, *available at* http://www.sec.gov/info/smallbus/sbforum.shtml

  SRLR ISSN 0037-0665

The staff recommended that the disclosure requirements relating to use of proceeds, offering expenses and the securities of a registrant could be revised with a focus on ''principles-based'' requirements. As to use of proceeds disclosure under Item 701(f) (and 1933 Securities Act Rule 463), comments received by the SEC recommended the elimination of the continuing requirement to provide information in periodic reports regarding the application of offering proceeds inasmuch as cash is fungible and the discussion of cash flow in MD&A already covers material uses of cash.

A commenter on the SEC's JOBS Act website also recommended elimination of the historical stock price disclosure requirements mandated by Item 201 of Regulation S-K, given the availability of such data on most finance websites. Other commenters recommended eliminating the requirement in Item 507 to name each selling stockholder in an offering as not being relevant to investors.

Corporate Governance. The staff recommended that corporate governance disclosure requirements be reviewed to confirm whether material information is disclosed effectively to investors. The staff called for evaluating alternative forms of presentation for corporate governance disclosure in Item 407 of Regulation S-K, such as including the information in a filing that is updated only when changes occur.

Executive Compensation. The staff acknowledged that executive compensation disclosure in Item 402 of Regulation S-K has become ''lengthy'' and ''technical,'' and should be reevaluated in light of those concerns and the usefulness of certain executive compensation disclosure requirements to investors. The staff stated also that it may be appropriate to recommend further scaling of executive compensation disclosure for smaller public companies.

In Certain Relationships and Related Party Transactions disclosure, a comment submitted to the SEC's JOBS Act website recommended revising the bright-line quantitative disclosure threshold of $120,000 for related party transactions in Item 404 of Regulation S-K to provide for a scaling test based on the size of the issuer and the nature of the transaction.

Financial Reporting and Disclosure. The SEC's press release announcing the staff's report stated that the SEC's Office of the Chief Accountant will coordinate with the Financial Accounting Standards Board to identify ways to improve the effectiveness of disclosures in corporate financial statements and to minimize redundancy with other existing disclosure requirements. The staff indicated that this may touch upon Regulation S-K requirements for annual and quarterly selected financial data disclosure in Item 301 and the ratio of earnings to fixed charges in Item 503(d) of Regulation S-K.

Further, it was recommended that the staff's comprehensive review include the disclosure requirements contained in related rules and forms, such as Form 10-Q and 8-K, in connection with the presentation and delivery of information to investors, including a possible filing and delivery framework based on the nature and frequency of disclosures.

Additional Items. *Exhibit Filings* – The staff indicated that it would be beneficial to reevaluate the manner in which exhibits are made publicly available on the SEC's website, as some exhibit filings can be difficult to locate if not cross-referenced precisely and whether revisions should be made to the types of required documents that must be filed.

Item 10 Issues – The staff suggested possible reevaluation of the disclosure requirements relating to (i) the SEC's policy on the use of securities ratings in filings, (ii) conditions for the use of non-generally accepted accounting principles financial measures and (iii) scaled disclosure for smaller reporting companies.

Emerging Growth Companies – The staff recommended consideration of the criteria to be used for purposes of EGC eligibility under Securities Act Section 2(a)(19) and whether other companies that do not meet all of the EGC criteria (such as having had their IPOs declared effective on or prior to Dec. 8, 2011) should nonetheless be eligible for similar scaling or phasing-in of their disclosure requirements, which would require enactment by Congress. Along with that, the staff suggested further consideration of the non-affiliate market capitalization thresholds for smaller reporting companies, accelerated filers and large accelerated filers in Rule 12b-2 of the 1934 Securities Exchange Act.

Industry Guides – The staff recommended a review of its Industry Guides to evaluate whether they still provide useful information and conform to industry practices and trends. Specifically, the staff mentioned Industry Guide 3 for financial institutions, in view of the industry's growth and complexity, as well as developments in international regulatory reforms, and Industry Guide 5 for real estate companies, in light of changes in business and financial practices. The staff questioned whether the Guides should be folded into Regulation S-K, whether they are sometimes duplicative with accounting standards and whether scaled disclosure of the Guides' rules should be available for smaller issuers.

Economic Considerations to Be Weighed for Rule Changes. In looking at any disclosure changes, the staff laid out seven prerequisite economic principles to rule changes:

- any change should improve and maintain the informativeness of disclosure to existing security holders, potential investors and the marketplace;
- after considering the historical objectives of the given rule (including the disclosure gap that had existed and associated policy objectives), determine whether the initial conditions of the rule are still applicable or, if not, still pose a potential risk of returning;
- determine whether the information provided by a given rule is available to existing security holders, potential investors and the marketplace on a non-discriminatory basis from reliable sources other than the issuer;
- ascertain the extent to which a given disclosure requirement entails high administrative and compliance costs for companies;
- balance the extent to which disclosure of a company's proprietary information may have competitive or other economic costs;
- maintain the ability of the SEC to conduct an effective enforcement program with disclosures shown to be instrumental in the detection of fraud; and

■ recognize the importance of maintaining investor confidence in the reliability of public company information.

Further Study and Information Gathering Recommended Before Rulemaking. The staff's report recommended further study and information gathering before any new rulemaking in order to assemble a specific list of proposed Regulation S-K disclosure changes. The staff suggested that any such proposals should:

■ emphasize a ''principles-based'' approach where companies would be expected to take the lead in identifying material information from the perspective of a reasonable investor rather than simply responding to a static list of potentially relevant line-item disclosure requirements;

■ include an evaluation of the appropriateness of scaled disclosure requirements;

■ provide an evaluation of methods for information delivery and presentation, both through the EDGAR system and other means; and

■ consider ways to present information that would improve the ''readability and navigability'' of disclosure documents and explore methods for discouraging repetition and disclosure of immaterial information.

The staff also stated that input from market participants is necessary to help identify ways to update or add requirements for disclosure that is material to investment and voting decisions, to streamline or simplify disclosure requirements to reduce public companies' costs and burdens and to understand how new technology can be used to improve the presentation and communication of disclosure.

Final Note on Staff's Recommendations

The staff of the SEC has articulated a strong case that a comprehensive review of Regulation S-K is overdue. As securities attorneys, we have seen the disclosure under Regulation S-K become overblown with the addition of new items and subsections, through SEC concept and interpretative releases, policy statements and compliance and disclosure interpretations prompting disclosure not clearly required by the strict language of Regulation S-K, and through staff comments on registration statements under the Securities Act and periodic reports under the Securities Exchange Act with inconsistent interpretations of disclosure rules. This trend is reflected in a study by several Silicon Valley law firms in which they reported the average length of final prospectuses of 22 technology and life sciences companies that completed IPOs after Dec. 8, 2011 and qualified as EGCs was 183 pages.[4] Less than 20 years ago, under essentially the same statutory disclosure requirements, the firms found that IPO prospectuses were considered large if they contained more than 100 pages.

If your company is serious about trying to go public in 2014, a fresh look at your disclosure can lead to a more streamlined and focused prospectus that will likely speed your way through the SEC review process. In many areas, disclosure should be based upon consideration of what is relevant and appropriate to an understanding of your company, its business and the securities being issued, and not necessarily upon those requirements the staff has already set aside for reevaluation or a desire to simply replicate the boilerplate disclosure of previous issuers. Until the SEC formally adopts changes to Regulation S-K, the staff's Dec. 20 report represents its most recent position on multiple disclosure requirements.

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[4] Letter from Fenwick & West LLP, Cooley LLP and Wilson Sonsini Goodrich & Rosati PC, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (June 19, 2012), *available at* http://www.sec.gov/comments/jobs-title-i/reviewreg-sk/reviewreg-sk-1.pdf.

  SRLR ISSN 0037-0665