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ABA Federal Regulation Of Securities Committee Makes Recommendations On Regulation S-K

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On March 6, 2015, the Federal Regulation of Securities Committee (“Committee”) of the American Bar Association (“ABA”) submitted its second comment letter to the SEC making recommendations for changes to Regulation S-K. The Committee’s recommendations are aimed at improving the quality of business and financial information that must be disclosed in periodic reports and registration statements in accordance with Regulation S-K. I note that I am a member of the Committee, but not a member of the sub-committee that drafted the comment letter, nor did I have any input in regard to the comment letter.

The recommendations fall into four major categories: materiality; duplication; consolidation of existing interpretive and other guidance from the SEC; and obsolescence. The recommendations in the letter are based on themes articulated by the Division of Corporation Finance in a 2013 report to Congress mandated by the JOBS Act and subsequent speeches by the Division’s Director, Keith F. Higgins.

Materiality

The Committee’s letter recommends that many of the Regulation S-K line items be qualified with a “materiality” standard, with materiality being determined by “information that a reasonable investor would deem important in making investment and/or voting decisions.” The SEC must balance the goal of ensuring relevant disclosures to make informed investment decisions with the equally important consideration of “compliance costs to companies, and the potential impact on efficiency, competition and capital formation.” These goals sometimes require the disclosure of information not specifically delineated in Regulation S-K to ensure that a disclosure is not misleading and complies

with the anti-fraud standards. The same standards should work both ways, allowing the elimination of delineated line items where such information is not material and would not result in making other information misleading by its absence.

The principles-based materiality standard should not apply to all disclosures. For example, the quantitative standards for reporting related party transactions and executive compensation should remain.

The Committee letter specifically recommends that the SEC amend Item 10 of Regulation S-K (i.e., general instructions to Regulation S-K) to include the following text:

“(g) In addition to the information expressly required to be disclosed, the registrant shall disclose such additional material information, if any, as may be necessary to make the required statements in the light of the circumstances under which they are made not misleading, and issuers may omit information otherwise called for by a line item on the ground that it is not material, as long as the effect of omitting the information would not be misleading. It shall be presumed, in the absence of facts to the contrary, that the omission of any disclosure called for by a Regulation S-K line item was an intentional omission by the registrant in reliance upon this sub-section (g) and not a failure to provide the disclosure called for by such line item.”

In addition to the recommended change to Item 10, the Committee made numerous other specific recommended changes to Regulation S-K line item, including:

- (i) Addition of the materiality qualifier to Item 101(d) related to financial information about geographical areas;
- (ii) Increasing the disclosure standard for government-related litigation proceedings in Instruction 5(C) of Item 103 from \$100,000 to \$1,000,000;
- (iii) Reducing the look-back period for Item 301 selected financial information disclosure from 5 years to 3 years unless the inclusion of all 5 years is necessary to illustrate or evidence a material trend;
- (iv) Addition of the materiality qualifier to Item 303 management discussion and analysis-related disclosure of year-to-year changes of delineated line items; and
- (v) Addition of the materiality qualifier to Item 601 requiring the filing of exhibits.

Although I think the Committee's recommendation is excellent in concept, I think the presumption that disclosure omissions are intentional will make setting internal review standards for the SEC staff difficult. In the event of these changes I would foresee a new set of standard comments from the SEC asking the registrant to confirm that the omission of information was intentional and that the materiality standard had been considered and applied.

Duplication

The Committee recommended three sets of changes to reduce duplication: (i) amendments to Exchange Act Rule 12b-23(a)(3) to facilitate incorporation by reference; (ii) adding a new SEC stated policy requiring the reduction of duplication and increase of cross-references; and (iii) specific Regulation S-K amendments. In addition, the Committee recommended allowing registrants the flexibility of deciding where to include information in a report or registration statement without have to cross-reference that information in other sections of the same report.

The Committee letter specifically recommends that the SEC amend Item 10 of Regulation S-K (i.e., general instructions to Regulation S-K) to include the following text:

“(h) Commission Policy on Avoidance of Duplication. The Commission encourages registrants to view each periodic report and each registration statement as a single, unitary disclosure document. To the extent disclosure required under a specific item of Regulation S-K is in the document, registrants are not required to repeat the same disclosure elsewhere in the document, including, without limitation, Risk Factors or Management's Discussion and Analysis of Financial Condition and Results of Operations, or to include cross-references to the same disclosure. The one exception to this principle is the financial statements and notes to the financial statements, which should be considered a standalone section; cross-references should not be used to satisfy disclosure requirements applicable to the financial statements or notes to the financial statements. However, where the financial statements and notes to the financial statements include disclosure that is responsive to Regulation S-K items, the registrant may include a cross-reference to the relevant financial statement disclosure to satisfy the Regulation S-K requirement if it determines that the cross-reference is appropriate. The EDGAR version of the document filed with the Commission must contain a live hyperlink to any disclosure that is being cross-referenced.”

In addition to the recommended change to Item 10, the Committee made numerous other specific recommended changes to Regulation S-K line item, including:

- (i) Delete Item 101(b) requiring financial information for segments as the information is already included in either the financial statements themselves or MD&A;
- (ii) Qualify Item 101(c)(ix) requiring disclosure of the renegotiation or termination of government contracts such that the disclosure is not required if provided elsewhere in the report or registration statement;
- (iii) Delete Item 101(d) requiring financial information about geographic areas as the information is already included in either the financial statements themselves or MD&A;
- (iv) Add guidance to Item 303 – critical accounting estimates and assumptions – so that it only includes material supplemental information and does not repeat the notes to the financial statements;
- (v) Add instructions to Item 303(a)(1) – liquidity – such that disclosure does not need to be repeated if already included in the notes to financial statements;
- (vi) Add instructions to Item 303(a)(4) – off-balance sheet arrangements – such that disclosure does not need to be repeated if already included in the notes to financial statements;
- (vii) Add instructions to Item 303(a)(5) – tabular disclosure of contractual obligations – such that disclosure does not need to be repeated if already included in the notes to financial statements;
- (viii) Add instructions to Items 503(a) and Item 301 regarding selected and summary financial information such that to the extent information is included in Item 301 it is not duplicated in Item 503;
- (ix) Add instructions to Items 503(a) and 503(c) – risk factors – allowing a cross-reference to risk factors in the summary of risk factors instead of repetition; and
- (x) Add instructions to Item 503(c) – risk factors – allow the setting out of the forward-looking statements disclosure as a separate section and to the extent such disclosure includes risk factors, such risk factors need not be included in the separate risk factor section.

Guidance Consolidation

The SEC provides a significant amount of guidance on Regulation S-K, including the Division of Corporate Finance's Financial Reporting Manual, Interpretative Releases, Compliance Disclosure and Interpretations (CD&I), no action letters, interpretative releases, speeches, and sample letters to public companies, all of which is generally available on the SEC website.

The Committee letter recommends that the SEC consolidate all available guidance on MD&A in a single source. The Committee notes that MD&A is the most significant area of disclosure and that the guidance is voluminous and widespread. In order to facilitate the consolidation, the Committee recommends that the SEC provide a single source for all guidance, with hyperlinks to existing timely authoritative guidance. The guidance should be organized by subtopic with specific cross-references.

Obsolescence

Many of the Regulation S-K disclosures date back to the adoption of Regulation S-K in 1982 and some disclosure requirements are obsolete or no longer relevant. In that regard, the Committee made numerous other specific recommended changes to Regulation S-K line items, including:

- (i) Changes to Item 101(e)(2) and (e)(4) – available information – regarding obtaining information from the SEC or the issuer by written request (everything is available online now...);
- (ii) Item 201(a)(1), 201(c) and 202(e) – market information and historical dividends – should be eliminated as all market information is readily available online;
- (iii) Remove Item 201(d)(3) regarding disclosure of non-shareholder approved equity compensation plans – this information is readily available from other sources and registered exchanges require a shareholder vote for all plans;
- (iv) Item 503(d) – ratio of earning to fixed charges and Item 601(b)(12) – computation of such ratios – both items should be eliminated – this is rarely used and many other metrics provide higher-quality information;
- (v) Item 506 – dilution – this information is not useful to investors and can be confusing both to the registrant trying to provide the disclosure and the investor receiving the

information. In addition, this disclosure focuses on net tangible book value per share, which does not provide meaningful information for a going concern business; and

(vi) Item 512(e) – incorporated annual and quarterly reports – such reports are readily available online.

Conclusion

The Committee continues to review Regulation S-K for additional recommendations to the SEC to improve the quality of business and financial information that must be disclosed in periodic reports and registration statements. All practitioners and companies agree that such improvement is necessary.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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