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Securities Law ADVISORY ■

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SEC Amends Regulation S-K Disclosure Requirements and Updates Definitions of "Accredited Investor" and "Qualified Institutional Buyer"

On August 26, 2020, the Securities and Exchange Commission (SEC) adopted amendments to Regulation S-K, including disclosure requirements for the description of a company's business, legal proceedings, and risk factors. For the most part, the amendments continue the SEC's push to a principles-based approach and are rooted in materiality requirements that seek to improve disclosures for investors and simplify compliance for registrants. The amendments follow proposed rules as part of the SEC's ongoing effort to improve the readability of disclosure documents to provide investors with relevant information to make investment decisions.

In addition, in a separate release on the same date, the SEC approved amendments to the definitions of "accredited investor" and "qualified institutional buyer" under the Securities Act of 1933, as amended. These amendments expand the list of those eligible to participate in private investment opportunities

The adopting release for the modernization of Regulation S-K is available here, and the proposing release is available here. These amendments will become effective 30 days after publication in the *Federal Register*. Our prior securities advisory covering the proposing release to the changes to Regulation S-K is available here.

The adopting release on the amendments to the definitions of "accredited investor" and "qualified institutional buyer" is available here, and the proposing release is available here. The amendments to these definitions will become effective 60 days after publication in the *Federal Register*.

The amendments make changes to the following:

- General Development and Narrative Description of Business (Items 101(a), 101(c), and 101(h) of Reg S-K)
- Legal Proceedings (Item 103 of Reg S-K)
- Risk Factors (Item 105 of Reg S-K)
- Definition of "accredited investor" under Regulation D
- Definition of "qualified institutional buyer" under Rule 144A

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Amendments to Regulation S-K

General Development and Narrative Description of Business (Item 101(a) and 101(h))

Five-year timeframe eliminated

Item 101(a) of Regulation S-K has been amended to require disclosure of information that is material to an understanding of the general development of the business, irrespective of time. The previously prescribed five-year timeframe for this disclosure has been eliminated, shifting the focus to what is most important to investors. A corresponding change to Item 101(h) eliminated the three-year limitation for this disclosure requirement for smaller reporting companies.

Updates to the business developments disclosure (vs. full discussion)

Items 101(a)(1) and 101(h)(1) of Regulation S-K were amended to allow registrants to focus on material business developments in filings that follow an initial registration statement in order to present the most relevant information to investors. Registrants must include a hyperlink to the last filing that contained a full discussion of the development of the business and incorporate that discussion by reference. Note, the adopting release specifies that a registrant is only permitted to incorporate the full discussion of the general development of its business from a single previously filed document, not multiple filings, so a restatement of the full description may still be desirable if there are multiple updates.

Additional requirement to include disclosure of material changes to business strategy

The amendments to Item 101(a)(1) of Regulation S-K added a requirement for registrants to disclose material changes to its previously disclosed business strategy while retaining existing disclosure requirements related to bankruptcies, receiverships, material reclassifications, mergers or consolidations, and material acquisitions or dispositions of assets.

The SEC also adopted amendments to Item 101(a)(1) that provide a more principles-based approach to disclosures by replacing the list of prescribed disclosure topics with a nonexclusive list of the types of information that registrants may need to disclose, and clarifying such disclosures are required only when necessary to an understanding of the registrant's business.

Narrative Description of Business (Item 101(c))

Nonexclusive list of disclosure topics

Importantly, the SEC adopted amendments to Item 101(c) of Regulation S-K to include a nonexclusive list of disclosure topics for registrants to consider and require disclosure only if the topic is material to an understanding of the registrant's business. These topics include:

- Revenue-generating activities, products and/or services, and any dependence on revenue-generating activities, key products, services, product families, or customers, including governmental customers.
- Status of development efforts for new or enhanced products, trends in market demand, and competitive conditions.
- Sources and availability of raw materials.

- The importance, duration, and effect of all patents, trademarks, licenses, franchises, and concessions held.
- A description of any material portion of the business that may be subject to renegotiation of profits or termination of contracts or subcontracts at the election of the government.
- Extent to which the business is or may be seasonal.
- Material effects of compliance with material government regulations (not just environmental regulation).

Additionally, if any of this information is material to a particular segment, that segment should be identified. Although working capital practices, disclosure about new segments, and dollar amounts of backlog orders believed to be firm have been removed from this list, the SEC expects that these topics will be covered in other required disclosures to the extent they are material.

Human capital

In light of the increased importance of human capital as a resource and driver of performance in the businesses of a number of registrants, the amendments require registrants to provide a more fulsome description of their human capital resources. The rules provide a principles-based approach, rather than providing prescriptive requirements, but the new disclosure should include any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of a registrant's business.

This additional requirement for disclosure of human capital and human capital management may generate the most additional work among registrants. Making a materiality assessment and crafting disclosure will require discussions across the organization. Registrants should begin early to consider and make human capital management assessments and whether it may be material to investors.

Registrants must also continue to disclose the number of people it employs to the extent that information is material to an understanding of the business. Although the proposed rules would have eliminated this requirement, the staff agreed with several commenters that this requirement should be retained.

Legal Proceedings (Item 103)

The amendments make two important changes to legal proceedings disclosure required by Item 103 of Regulation S-K. The first, which has become a common practice of registrants, expressly permits registrants to satisfy obligations under Item 103 by referencing legal proceedings disclosures in other parts of the document, such as MD&A, risk factors, or a note to the financial statements.

The second amendment increases the threshold amounts for required disclosure of environmental proceedings involving a governmental authority. The amendment updates the disclosure threshold from $100,000, where it has remained since it was adopted in 1982, to $300,000. The $300,000 threshold is approximately the same as the previous $100,000 threshold adjusted for inflation. In addition, registrants will have the option to select an alternative threshold for disclosure of such matters that is reasonably designed to result in the disclosure of proceedings that are material to its business or financial condition. However, the disclosure threshold may not exceed the lesser of $1 million or 1 percent of the current assets of the registrant and its subsidiaries on a consolidated basis. Any registrant that chooses to use a threshold

other than the $300,000 threshold must disclose this threshold (including any changes) in each annual and quarterly report.

Risk Factors (Item 105)

In the current environment, risk factor disclosure has become an increasingly burdensome requirement for registrants. Item 105 of Regulation S-K requires that the most significant factors that make investing in a registrant's securities or offering risky to be disclosed in a manner that is concise and logically organized. To address the amount of increasingly lengthy risk factor disclosures, the SEC has adopted three amendments to Item 105 to encourage registrants to thoughtfully think about risk factor disclosure.

First, the amendments require a risk factor summary of no more than two pages (in bulleted or numbered format) if the risk factor section exceeds 15 pages. The summary risk factor disclosure must be provided in the beginning of the SEC-filed document under an appropriately titled heading.

Second, Item 105 now requires registrants to provide risk factors related to the material risks of a registrant's business rather than those that are the "most significant" to the registrant. The change in the disclosure standard is intended to result in more tailored disclosures rather than the lengthy set of risk factors that are often included in company filings. However, many registrants have already been including what they believe are the material risks to their company.

Lastly, Item 105 now requires risk factors to be organized under relevant headings. This last amendment codifies a practice that has been largely adopted by registrants. This amendment also requires a separate heading for any "General Risk Factors" that may apply to any investment in securities and requires those to be disclosed at the end of the risk factor section.

Registrants are encouraged to review their risk factors and ensure they are considering risk factors that are customized and particular to their business.

Amendments to the Definition of "Accredited Investor" and "Qualified Institutional Buyers"

New Categories of Natural Persons as Accredited Investors

The SEC adopted amendments to add two new categories of natural persons to the accredited investor definition: (1) persons holding certain professional certifications, designations, or other credentials; and (2) persons who are "knowledgeable employees" of a private fund.

In addition, Rules 501(a)(5) and 501(a)(6) under the Securities Act were revised to allow "spousal equivalents" to pool finances for purposes of determining whether the joint income and joint net worth tests are met to qualify as accredited investors, and a note was added to Rule 501 to clarify that for the purposes of Rule 501(a)(5), the calculation of joint net worth can be the aggregate net worth of the investor and the investor's spouse (or spousal equivalent) and that the securities need not be purchased jointly.

Professional certifications

The amendments enable holders of certain professional certifications, designations, and credentials to qualify as accredited investors even when they do not meet the income or net worth requirements of the

definition. Given the evolving nature of market and industry practices, the amendments allow the SEC to periodically evaluate the designated list of certifications, designations, or credentials and update the list by order if new ones are identified that would be appropriate to be added to the accredited investor definition. Pursuant to a separate order, holders of the following certifications or designations administered by the Financial Industry Regulatory Authority are deemed accredited investors: Series 7, Series 65, and Series 82 licenses that are in good standing.

Knowledgeable employees

As adopted, the amendments create a new category of "knowledgeable employees" (as defined in Rule 3c-5(a)(4)) of a private fund that qualify as accredited investors. Among others, knowledgeable employees will include trustees, advisory board members, and employees who have participated in the investment activities of the private fund for at least 12 months, so long as they do not perform solely clerical, secretarial, or administrative functions. This new category is similar to the existing category for directors, executive officers, or general partners of other issuers.

New Categories of Entities as Accredited Investors

The amendments also increase the number of entities that currently qualify as accredited investors. The change updates the previous list found in Rule 501(a) and eliminates confusion for entities that are legally similar but not explicitly enumerated in Rule 501(a).

Registered investment advisers and rural business investment companies

The amendments add to the list of entities that qualify as accredited investors: (1) investment advisers that are registered under Section 203 of the Investment Advisers Act of 1940; (2) investment advisers registered under the laws of various states; and (3) exempt reporting advisers under Section 203(l) or 203(m) of the Advisers Act. The change is based on changes in the securities law landscape. Some investment advisers already qualify as accredited investors under the Rule 501(a)(3) threshold (having total assets exceeding $5 million and not formed for the specific purpose of acquiring the securities being offered). The amendment has the effect of including the other registered or exempt investment advisers in the definition of accredited investors regardless of the $5 million asset threshold.

Similarly, rural business investment companies (RBIC) have been added to the definition of accredited investors. RBICs are companies that are approved by the Secretary of Agriculture and promote economic development and wealth creation in rural areas. Small business investment companies share a common purpose of promoting capital formation with RBICs and are already recognized as accredited investors. The amendment creates equal treatment for the two types of entities.

Limited liability companies

Due to the increased prevalence of limited liability companies (LLCs) as business entities, the amendments include LLCs with at least $5 million in assets as accredited investors under Rule 501(a)(3). LLCs were not previously included in the rule's list of qualified entities. This amendment codifies the SEC's longstanding position that LLCs satisfying the other requirements of Rule 501(a)(3) qualify as accredited investors.

Other entities meeting an investments-owned test

The amendments also created a new catch-all category for entities in Rule 501(a)(9) for any entity owning "investments," as that term is defined in Rule 2a51-1(b) under the Investment Company Act, exceeding $5 million that is not formed for the specific purpose of acquiring the securities being offered. The intent of this new category is to capture all existing entity forms not already included within Rule 501(a), such as Indian tribes and governmental bodies, as well as those entity types that may be created in the future.

Family offices and family clients

Under the new rule, "family offices" with at least $5 million in assets under management along with their "family clients," as each term is defined in the Advisers Act, are added to the list of entities that are accredited investors. The new definition applies only to family offices (1) that are not formed for the specific purpose of making the investment in question; and (2) whose investment is directed by a person with the knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment.

Qualified Institutional Buyer

The definition of "qualified institutional buyer" has also been amended to include RBICs and LLCs that meet the $100 million in owned and invested assets threshold. The amendment further changes Rule 144A under the Securities Act to reflect the changes to Rule 501(a).

In addition, a new paragraph (J) has been added to Rule 144A(a)(1)(i). The new rule allows any institutional accredited investor under Rule 501(a) that is not specifically listed in Rule 144A to qualify as a qualified institutional buyer once it satisfies the $100 million threshold.

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