Securities Regulation Daily Wrap Up, TOP STORY—Human capital tops Reg. S-K amendments, but debate over direction of disclosure mandates looms, (Aug. 26, 2020)

Securities Regulation Daily

Click to open document in a browser

By Mark S. Nelson, J.D.

The SEC adopted amendments to Regulation S-K in furtherance of its ongoing disclosure modernization and effectiveness initiative while separately adopting an expanded definition of "accredited investor."

A divided Commission adopted two sets of regulatory amendments, one that will further the SEC's ongoing disclosure effectiveness initiative, and the other designed to expand who may be an accredited investor. The revision to the accredited investor definition was adopted seriatim by a 3-2 vote, while the Regulation S-K disclosure amendments were adopted by a 3-2 vote at a contentious open meeting, from whose agenda the accredited investor issue recently had been dropped. However, the debate among the commissioners over both sets of amendments brought into the open sharp divisions about the role of federal securities regulations in protecting investors and simultaneously freeing investors to partake of more investing options (*Modernization of Regulation S-K Items 101, 103, and 105*, Release No. 33-10825, August 26, 2020; *Amending the "Accredited Investor" Definition*, Release No. 33-10824, August 26, 2020).

Key Reg. S-K changes. The Commission's Regulation S-K revisions address the requirements for making disclosures about a company's business description, a company's risk factors, and environmental and human capital issues (See also, Regulation S-K proposal and comments). The most controversial change is likely the one addressing the latter two items on environmental and human capital disclosures. Specifically, a company must make environmental and human capital disclosures of information that is material to an understanding of its business as a whole (a company also must identify any segment of its business for which the information is material).

For example, Item 101(c)(2) of Regulation S-K applies generally to a company's compliance with government regulations. Disclosure would cover the company's capital expenditures, earnings, and competitive position. Related environmental disclosures would include estimated capital expenditures for environmental control facilities for both the current fiscal year and other material subsequent periods. A separate amendment to the legal proceedings disclosure required by Item 103 of Regulation S-K increases the threshold for disclosure of government environmental proceedings against a company (e.g., sanctions of $300,000 instead of $100,000) and allows a company, subject to limits, to elect another threshold.

As another example, Item 101(c)(2)(ii) requires a company to: (1) describe its human capital resources; (2) state the number of persons it employs; and (3) describe human capital measures or objectives that the registrant focuses on in managing the business which, depending on the nature of the company's business and workforce, should emphasize development, attraction and retention of personnel.

With respect to risk factor disclosures under Item 105 of Regulation S-K, the main differences between the current version and the revised version are the following:

- The threshold for disclosure of a risk factor will shift from the current "most significant factors" to "the material factors," a change that could result more or less disclosure depending on whether an item is material rather than significant. The emphasis on materiality, however, is consistent with the Clayton-era SEC's tendency to emphasize materiality, the general touchstone for federal securities disclosures in other areas, such as companies' cybersecurity disclosures.

- Instead of totally discouraging the inclusion of generic risk factors (although they are still generally discouraged), the Commission would allow companies to include such risk factors at the end of the risk factors section in a section captioned "Generic Risk Factors."
- Risk factors will need to be presented with more structure. Currently, risk factors must have appropriate subcaptions, but under revised Item 105 they must have both relevant headings and subcaptions.
- If the risk factors section runs over 15 pages, a company must include a summary risk factors section in the forepart of the prospectus or annual report. The summary is limited to two pages in length.

The amendments regarding generic risk factors also attempt to account for litigation risks. The primary rationale for the revision, as cited in the proposing release, was that companies include too many generic risk factors and, thus, the ever-growing risk factors disclosure is becoming cumbersome to investors. As the proposal further noted, the growth of the risk factors section is partially tied to the risk of litigation if a company does not disclose generic risks.

Things missing from Reg. S-K release? SEC Chairman Jay Clayton opened the Regulation S-K meeting by characterizing the recommendation before the Commission as "deferred maintenance" for a regulation that had not been updated in more than 30 years. The chairman explained that the revisions are largely principles-base and said he "fully support[s]" the new human capital disclosures because human capital drives long-term value of companies more than ever before. He also said the principles-based disclosure framework allows for some flexibility in human capital metrics but that he expects meaningful qualitative and quantitative disclosures. Commissioner Elad Roisman likewise noted the shift from prescriptive regulations to more principles-based regulations and the concomitant shift from a manufacturing economy to one driven increasingly by intangible assets.

According to Commissioner Hester Peirce, the Regulation S-K amendments are "common sense reforms," although she would have gone even further to eliminate any prescriptive requirements, such as the requirement that a company state the number of employees it has. Commissioner Peirce also suggested that the summary risk factor section was an "experiment" in disclosure: "Will the penalty of having to prepare a summary be sufficient to overcome the fear of litigation that pushes companies to disclose many pages of risks?"

Commissioner Allison Herren Lee dissented because the Regulation S-K release was silent about diversity and climate risk. She said she had voted for the proposing release in hope of a better final rule, but that the majority had ignored the thousands of comments asking for more disclosure on these topics. "It has never been more clear that investors need information regarding, for example, how companies treat and value their workers, how they prioritize diversity in the face of profound racial injustice, and how their assets and business models are exposed to climate risk as the frequency and intensity of climate events increase," said Lee. "This year's upheavals have driven home that ESG risks, like those associated with diversity and climate change, are strong predictors for resilience and for maximizing risk-adjusted returns."

Newly sworn-in Commissioner Caroline Crenshaw also objected to the omission of diversity and climate issues from the adopting release, characterizing the inattention to these issues as "a failure to modernize." Said Commissioner Crenshaw: "I am concerned that today—in the middle of a crisis affecting all aspects of our market—the majority of the Commission is failing to take the opportunity to provide investors with critical and useful information about key corporate metrics."

With respect to human capital and the COVID-19 pandemic, Commissioner Crenshaw mulled what disclosures would have been made already if, in the last several years, there had been in place a more rigorous human capital disclosure regime. "Imagine if companies had been required to disclose key human capital metrics prior to 2020, like workplace flexibility and safety, and employee turnover rates. Investors would have had a basis to weigh the impacts of COVID-19 across sectors and would have been able to assess how companies would perform during this crisis."

According to Commissioner Crenshaw, the path forward for the SEC is to take two concrete steps: (1) create an internal task force to study how investors use information about human capital management, climate change

risk, and other environmental, social, and governance (ESG) metrics to assess long-term financial performance; (2) create an external ESG Advisory Committee.

The steps taken by the SEC's Regulation S-K release might be compared to legislative proposals on ESG topics floated by members of Congress. The legislative proposals generally have been far more prescriptive in nature, although some call for the SEC to develop ESG metrics. For example, the House Financial Services Committee reported the ESG Disclosure Simplification Act (H.R. 4329), sponsored by Rep. Juan Vargas (D-Calif), by a vote of 31-22 in September of 2019. The bill would emphasize sustainability, disclosure, and the use by public companies of SEC-defined ESG metrics. Bills like the Improving Corporate Governance Through Diversity Act of 2019 (H.R. 5084), sponsored by Gregory Meeks (D-NY), and which passed the House 281-135, would do much the same for diversity and inclusion by mandating issuer disclosures about their boardroom and C-suite diversity and inclusion efforts.

Debate over future direction of SEC disclosure mandates. At the conclusion of the SEC staff presentation and commissioners' formal statements, Commissioner Peirce began what would become a lengthy colloquy between Commissioner Peirce and Commissioner Lee over the direction of future Commission disclosure mandates. According to Commissioner Peirce, Commissioners Lee and Crenshaw favor a prescriptive approach over a principles-based approach. Commissioner Peirce characterized that debate as suggesting a bigger change than just the few specific disclosure items Commissioners Lee and Crenshaw mentioned in their statements.

Commissioner Lee replied that the Commission needs to have that conversation, despite the different views of specific commissioners. Commissioner Lee also noted that the Commission already has plenty of line-item requirements and that she would not eliminate all principles-based disclosures.

To this, Commissioner Peirce countered that line-item disclosures had not aged well. She also suggested that a shift to prescriptive disclosure requirements would require a degree of "wisdom" on the Commission's part that is greater than any five human beings can have because one cannot know enough about each company to say what is material for a particular company.

Commissioner Lee acknowledged Commissioner Peirce's point, but added that the notion that one cannot know such things should give pause because how would one know that a company's disclosures are material. Instead, Commissioner Lee said a regulator like the SEC must have both expertise and skepticism.

Commissioner Peirce then noted that Division of Corporation staff have many back-and-forth dialogues with companies regarding their disclosures. By way of background, those back-and-forth dialogues frequently occur through the SEC's filing review process and generate published comment letters and company replies on EDGAR. Commissioner Lee said she did not disagree with the capabilities of CorpFin staff.

Chairman Clayton concluded the exchange with several points of his own that, among other things, reiterated that the U.S. securities disclosure regime is the "envy" of the world and emphasized that diversity is important at the SEC because it is value-enhancing to an organization as a whole (the chairman directed listeners to the SEC's strategic plan and the SEC's revised board diversity Compliance and Disclosure Interpretations).

Accredited investor definition. The centerpiece of the revised definition of "accredited investor" is its expansion of the types of persons who can be accredited investors. Historically, an accredited investor was a particular type of financial institution or an individual of specified wealth. Those definitions remain largely untouched, but the adopting release adds language to include other persons within the definition of accredited investor. As a result, the definition will now include:

- Persons who hold a professional credential that the Commission has designated as indicative of accredited investor status. The SEC will publish such current designations on its website and can by order adopt more designations following notice and public comment. The Commission has already issued an order designating the following: (1) General Securities Representative license (Series 7), (2) the Private Securities Offerings Representative license (Series 82), and (3) the Investment Adviser Representative license (Series 65).

- Certain knowledgeable employees; and
- Family offices and family clients; a family office must have assets under management of more than $5 million, not be formed for the specific purpose of acquiring the securities offered, and the investment must be directed by a person with the requisite experience to evaluate the merits and risks of the investment.

Chairman Clayton lauded the release as a long-overdue revamp of the accredited investor definition. "Individual investors who do not meet the wealth tests, but who clearly are financially sophisticated enough to understand the risks of participating in unregistered offerings, are denied the opportunity to invest in our private markets. For example, using only a binary test for wealth disadvantages otherwise financially sophisticated Americans living in lower income/cost-of-living areas." He also deflected criticism that the expanded definition will increase private financings at the expense of initial public offerings, suggesting that there will be little impact on aggregate capital flows in public and private markets and insisting that the SEC remains committed to promoting U.S. public capital markets.

Commissioner Peirce said the amended definition was a "cautious expansion" of who may be an accredited investor, but she also questioned if the expansion goes far enough, citing the connections between freedom, responsibility, and liberty interests: "Why shouldn't mom and pop retail investors be allowed to invest in private offerings? Why should I, as a regulator, decide what other Americans do with their money?"

Likewise, Commissioner Roisman noted that "wealth is a crude measure" by which to judge a person's investment abilities. He also said future changes to the definition of accredited investor were possible and that a future Commission should ask if the monetary thresholds in the definition limit opportunities for women and minorities. With respect to the Commission order designating three professional credentials, Commissioner Roisman noted that holders of these credentials likely would also meet the wealth tests in the definition of accredited investor.

Commissioners Lee and Crenshaw jointly dissented from the accredited investor release. The commissioners objected to the lack of economic analysis justifying the revisions, the absence of an inflation adjustment to the net worth and income tests, and the general expansion of private capital markets and the associated risks, including risks to seniors. The first footnote to the joint dissent emphasized the rationale behind these critiques: "Private offerings lack the traditional investor protections that attach to registration, most importantly transparency and liquidity. Thus, the principal means of protecting investors in private markets is to work to ensure that those offering unregistered securities can only sell to investors who can assess and bear the heightened risks in private markets. Some argue that such an effort is paternalistic and that all investors should be free to risk their livelihoods as they see fit. But that evinces a disregard for the very reason the SEC was created and the fundamental differences between the public and private markets. The SEC's core mission is to protect investors and we should not substitute a policy of 'caveat emptor' for meaningfully carrying out that mission."

The accredited investor release also made some textual adjustments to the net worth and income tests for accredited investor status. For one, both the net worth and income provisions add language to make them applicable to a person's spouse or "spousal equivalent." The term "spousal equivalent" is defined to mean "a cohabitant occupying a relationship generally equivalent to that of a spouse." That definition is consistent with other uses of the term in federal securities regulations; the final release declined to adopt a different or more limited definition. Second, the release added a note to the net worth provision to clarify that net worth can be aggregate net worth. Moreover, to satisfy the joint net worth test, an asset need not be held jointly, and securities need not have been jointly purchased. However, the release did not alter the financial thresholds applicable to the net worth and income tests.

A question could arise whether there is any interaction between the expanded accredited investor definition and Regulation Best Interest. Regulation BI imposes enhanced requirements on broker-dealers who advise retail investors, including specific obligations regarding disclosure, care, conflicts of interest, and compliance. To be sure, there are few direct connections between the two regulations because accredited investors typically are

persons for whom formal disclosures are not needed because they can fend for themselves due to their financial sophistication or wealth. However, the SEC's Division of Trading and Markets has issued an FAQ that explains how Regulation BI may apply in some limited instances:

"Q: Does Regulation Best Interest apply to limited purpose broker-dealers, for example, broker-dealers that make recommendations of private offerings to accredited investors?"

"A: Yes, if that accredited investor is a 'retail customer' as defined in the rule. The definition of "retail customer" does not exclude high-net worth natural persons and natural persons that are accredited investors. Whether a broker-dealer engages in limited activity does not dictate whether or not Regulation Best Interest applies. Regulation Best Interest applies to broker-dealers that make recommendations of any securities transaction or investment strategy involving securities to retail customers. (Posted February 11, 2020)."

Lastly, the accredited investor release makes changes to the definition of "qualified institutional buyer" under Securities Act Rule 144A. Specifically, the release clarifies the eligibility of certain small business investment trusts, Internal Revenue Code Section 501(c)(3) entities' (adds limited liability companies), and institutional accredited investors (may be formed for the purpose of acquiring offered securities).

Early industry reaction. With respect to the accredited investor definition, Thomas Quaadman, executive vice president of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, praised the expanded definition. "By expanding the definition of accredited investor, the SEC is providing growing companies new sources of capital," said Quaadman

Meanwhile, Christopher W. Gerold, President of the North American Securities Administrators Association, said the SEC had missed an opportunity to revise the wealth thresholds for inflation and had instead taken a path that may favor private capital markets over public capital markets.

Better Markets' Lev Bagramian, senior securities policy advisor, suggested that both the Regulation S-K and accredited investor releases were an effort by a majority of the SEC to cater to Wall Street interests. Bagramian said amended Regulation S-K will give companies "undue flexibility" to make disclosures about their businesses while the expanded accredited investor definition blurs the distinction between investors who can fend for themselves and those who cannot.

The releases are Nos. 33-10825 and 33-10824.

MainStory: TopStory DoddFrankAct FedTracker Securities FormsFilings GCNNews InvestorEducation JOBSAct PrivatePlacements PublicCompanyReportingDisclosure SecuritiesOfferings