SEC in 2021

New Disclosure Requirements & Future Regulatory Changes

2021 CFO & Lending|Credit Conference

Presented by: Seth A. Winter, Partner

August 24, 2021

SEC in 2021; *New Disclosure Requirements & Future Regulatory Changes*

Regulation S-K Modernization (effective 2020)

Updating Risk Factors during COVID-19

MD&A Modernization (effective 2021)

Industry Guide 3 Modernization

New Insider Trading Enforcement – “Shadow Trading”

Environmental, Social and Governance (ESG) Initiatives

Definition of “Materiality”

“Materiality” means a substantial likelihood that information would be viewed by a reasonable investor as significantly altering the “total mix” of available information.

U.S. Supreme Court, in TSC v. Northway

In practice:

Information that is **merely interesting** is not material.

Significant is different than material.

Assessing materiality requires an analysis of all relevant facts and circumstances.

When assessing a contingency or risk, a materiality analysis must balance probability and potential magnitude.

Regulation S-K Modernization

SEC adopted updates to Regulation S-K in August 2020:

Item 101 – Description of Business

Item 103 – Legal Proceedings

Item 105 – Risk Factors

The August 2020 updates were first significant revisions to these items in 30 years.

Compliance was required beginning in November 2020 (e.g., registration statements), and updated disclosures appeared in 2020 Forms 10-K.

Regulation S-K Modernization;   Item 101

New requirement to describe a company's Human Capital Management resources, including any HCM objectives or measures that the company focuses on in managing its business.

No prescribed disclosure format. SEC is taking a "principles-based approach," but the SEC expects to see both quantitative and qualitative disclosures.

By terms of updated Item 101, this disclosure is only required if "material" … but in practice, most companies are providing this disclosure.

Can be challenging to identify, and describe, the HCM measures or objectives that a publicly-traded community bank uses in its business.

Regulation S-K Modernization; Item 101

Developing best practices:

Board action to direct a committee to oversee HCM, ESG, and corporate social responsibility (CSR) matters and related disclosures

→ Some significant overlap among these areas, and potential efficiency in preparing/reviewing the HCM disclosure

Expect the new HCM disclosure requirements to be a “jumping off” point for expanded ESG disclosure requirements or expectations

Regulation S-K Modernization;   Item 103

Legal Proceedings disclosure now permitted to use hyperlinks or cross-references to disclosure located elsewhere in the same document.

There are very few reasons not to cross-reference to legal proceedings information provided in the financial statement notes (e.g., Commitments and Contingencies). Benefits of cross-referencing are:

- → Avoid inconsistencies within the document, which can happen when disclosure is being updated shortly before filing
- → More efficient; less time spent by service providers to review the disclosure

Disclosure required for any <u>material</u> legal proceedings, with additional flexibility to change applicable threshold for certain governmental environmental proceedings.

Regulation S-K Modernization; Item 105

Revised Item 105 only requires disclosure of "material" risk factors, to more closely align with other disclosure rules. Prior standard was "most significant."

Risk Factor Summary now required if a risk factor section exceeds 15 pages.

Risk factor summary must be limited to 2 pages. In practice:

→ A risk factor summary is often prepared by listing the risk factor subcaptions, or can be a condensed list similar to the list included in a forward-looking statement disclaimer

→ Companies may change formatting, font size, spacing, etc. to reduce risk factors in EDGARized document below 15 pages

Updating Risk Factors during COVID-19

A public company must update Risk Factor disclosure in Form 10-Q if there are any "material changes" from Risk Factors previously disclosed in the company's Form 10-K.

However, updating risk factors during COVID-19 poses some meaningful challenges:

→ Materiality analysis is difficult for contingent events and risks, and more difficult for extraordinary events like a global pandemic

→ Factual statements about COVID-19, and its status and impacts, contained within risk factors are no longer accurate. COVID-19 continues to develop rapidly.

→ Risks that were hypothetical when risk factor was filed may start to actually occur.

Companies should frequently return to definition of <u>material</u>. Merely interesting is not material.

Updating Risk Factors during COVID-19;   Practice Pointers

Do not try to hide an updated risk factor. The SEC Staff will strongly discourage a company from repeating a full set of risk factors in a 10-Q filing, except in the rare instance where each risk factor has materially changed.

Repeat updated risk factors. If a risk factor has materially changed and is updated in a 10-Q, the best practice is to include that updated risk factor in all subsequent 10-Q filings until the next 10-K.

Consider drafting revisions first. When analyzing if a risk factor has materially changed, it can be easier to (i) *first*, draft revisions to originally disclosed risk factor that are necessary to make the risk factor 100% accurate, and (ii) *second*, consult those revisions in a materiality analysis.

SRCs should consider including risk factors for protection against investor claims.

Risk Factor Litigation in 2021

US Court of Appeals, Ninth Circuit, upheld allegations that Alphabet, Inc. made materially misleading omissions by not updating risk factors to disclose that cybersecurity risks, previously disclosed as hypothetical, had materialized.

Allegations relate to data security vulnerabilities in Google+ social network that extended for 3 years. This breach was not disclosed by the company but the vulnerabilities ultimately became public.

Plaintiffs filed suit alleging securities fraud under Section 10(b) of the Exchange Act. The appeals court reversed an initial dismissal by the US District Court (N.D. Ca.).

Key evidence was internal reports prepared by the company discussing the severity of the security vulnerabilities, AND the media coverage and market reaction after the breach was disclosed.

Court opinion recognizes a significant difference to investors between "could occur" or "may occur" and "have already occurred."

MD&A Modernization

SEC adopted updates to Regulation S-K in November 2020 to update Item 303, Management's Discussion and Analysis.

As updated, MD&A must:

- → include "material information relevant to an assessment of the financial condition and results of operations" of the company, including an evaluation of cash flows from operations and outside sources
- → address material events and uncertainties known to management that are reasonably likely to case reported financial information to not be indicative of future operating results or financial condition
- → Include "material financial and statistical data" that the company believes will enhance a reader's understanding of the company's financial condition, cash flows and results of operations

The SEC's general goal is to elicit a less mechanical and more analytical discussion.

MD&A Modernization

The “reasonably likely” standard may present challenging disclosure questions to a public company. This standard requires a two-step process for evaluating potential disclosures:

First, is the event “reasonably likely” to occur based on management’s reasonable and objective assessment of all relevant facts and circumstances?

Second, if the event occurs, is the event likely to have a material effect on the company’s future results or financial condition?

Many companies may decide to take a conservative approach and over-disclose.

Consider documenting sensitive or “close” materiality analyses with a memo to file, containing a modified SAB 99 materiality framework.

MD&A Modernization

MD&A updates provide additional flexibility for interim reporting by permitting comparison of the current quarter to (i) same quarter of prior year, or (ii) sequentially linked quarter.

Publicly-traded BHCs and banks may not recognize full benefits of this flexibility, due to Industry Guide 3 and Subpart 1400 disclosure requirements.

If a company changes its presentation of interim financial information, the SEC expects the company to explain the reasons for the change and present both comparisons in the first 10-Q filing.

SEC Industry Guide 3 – Historical context

The SEC's Industry Guide 3 has required specific public disclosures from publicly-traded BHCs since the 1960s. Last substantive revision was in 1986.

Industry guides are SEC Staff guidance, not formally adopted regulations. SEC had requested comments on Guide 3 updates in 2017 and 2019.

Guide 3 was "ripe" for updating:

Guide 3 did not reflect certain updates to U.S. GAAP that have been made since Guide 3 was originally announced.

Certain Guide 3 categories don't match modern bank operations.

Guide 3 does not include many of the asset quality disclosures that are most commonly used by BHCs, or tracked by investors.

Industry Guide 3 will be replaced by new subpart of Regulation S-K.

In September 2020, the SEC issued final rules that:

→ rescind Industry Guide 3 effective January 1, 2023

→ adopt a new set of rules for financial disclosures by BHCs that will be codified in Subpart 1400 of Regulation S-K

Reporting BHCs must comply with Reg S-K, Subpart 1400 for fiscal years ending on or after December 15, 2021.

Most BHCs will be subject to these new rules for their 2021 annual reports, for year ended 12/31/21.

Registration statements must comply only when including financial statements for a period ended on or after 12/31/21.

Voluntary early compliance is permitted, as long as new rules are applied in their entirety.

What does Reg S-K, Subpart 1400 change?

SEC's intent was to eliminate inconsistencies and overlap with applicable requirements under U.S. GAAP (and IFRS).

Current disclosure requirements were retained, except that:

Average balance sheets and related disclosures – additional disaggregation of federal funds sold, securities purchased with agreements to resell, and securities sold under agreements to repurchase.

Investment Portfolio – can now use categories of securities required by GAAP; certain disclosures regarding book value (and maturity analysis) are no longer required.

Loan Portfolio – must now use loan categories required by GAAP, which will require inclusion of real estate mortgage loans, installment loans to individuals, and lease financing; certain disclosures regarding loan categories and portfolio risk elements are no longer required.

What does Reg S-K, Subpart 1400 change?

Allowance for Credit Losses – widest range of changes; additional disclosures of net charge-off ratio is required, and ACL allocation disclosure is based on categories used in the registrant's financial statements.

Deposits – new disclosures now required regarding uninsured deposits.

Performance Ratios – ROA, ROE, the dividend payout ratio and the equity to assets ratio from Guide 3 were not included in the final rules. The SEC believes its current guidance on MD&A requires registrants to use "Key Performance Indicators" which frequently will include ROA and ROE.

Short-term Borrowings – final rules do not include certain of Guide 3's disclosures regarding short-term borrowings, but final rules do require additional information for each material category of interest-bearing liabilities.

Interim Reporting Periods – registrants must provide updated disclosure for any interim period if there is a material change in the information, or a material trend, from the last annual period disclosure.

New statistical disclosures – Next steps for reporting banks

3Q21 and 4Q21:

– Work with accountants (and lawyers) to map Guide 3 disclosures to Reg S-K, Subpart 1400

– Financial reporting team to update format of tables used in MD&A and financial statement footnotes

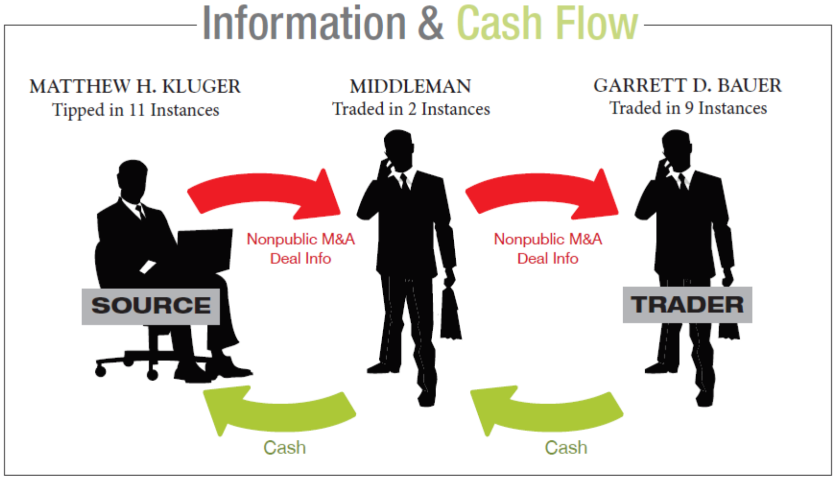
1Q22:

– Consider whether to plan for providing part 1400 disclosure in 10-Qs as a matter of practice, to avoid quarter-by-quarter analysis of whether a material update or trend is present

Despite the SEC's goal (and significant effort) to coordinate Guide 3 and GAAP, the updates contained in Subpart 1400 may require significant effort / energy to implement.

troutman pepper

Insider Trading – "Shadow Trading" developments



TRACKING the TRADES

INSTANCE	TRADER	SECURITY	ANNOUNCEMENT DATE	TRADING PROFITS
1	Bauer	Advanced Digital Information Corp.	5/2/2006	$1,724,000
2	Bauer	Acxiom Corp.	5/17/2007	$1,681,000

"Classical" insider trading involves trading by corporate insiders, on the basis of material nonpublic information (MNPI), that breaches a duty owed to shareholders.

"Misappropriation" insider trading involves trading by corporate outsiders, on the basis on MNPI, that breaches an obligation or expectation of confidentiality.

Insider Trading – "Shadow Trading" developments

In August 2021 the SEC brought an insider trading suit on a third basis, which academics but not the SEC call "Shadow Trading."

Step 1 → Pharma exec learns that his own company, Medivation, is going to be acquired by Pfizer.

Step 2 → Pharma exec believes that this transaction will increase the stock prices of companies that are comparable to Medivation.

Step 3 → *Minutes after learning about Pfizer's offer*, Pharma exec acquires short-term stock options in a rival pharma company using his work computer.

Step 4 → Pfizer's acquisition of Medivation is announced. Market prices of rival firms increase, and short-term options doubled in value.

This enforcement action may define a new area of insider trading law and encourage additional prosecutions. This is a great set of facts for the SEC.

troutman pepper

Insider Trading – "Shadow Trading" developments

Most insider trading policies already try to protect against behavior that could constitute "shadow trading."

Extremely common for an insider trading policy to restrict trading on the basis of material nonpublic information in securities of any publicly-traded company.

Some tension between "industry expertise" and knowledge that is informed by nonpublic information. New theory could be very significant for private investment funds.

Shadow trading theories may impact other work by the SEC on insider trading.

SEC may be revisiting Rules 10b5-1 and 10b-18 which govern stock repurchase plans, to restrict start / stop / pause activity.

Environmental, Social and Governance (ESG) Initiatives

The SEC is focusing attention on ESG matters, and discussions about whether the SEC should require ESG disclosures from public companies.

SEC Chair Gary Gensler tweeted: *"When it comes to [ESG] disclosure, investors have told us what they want. It's now time for the commission to take the baton."*

Recent SEC proposal to expand climate change disclosures attracted more than 400 comment responses, many of which asked for a more robust assessment and reporting framework for ESG risks.

Environmental, Social and Governance (ESG) Initiatives

Chair Gensler has publicly outlined an SEC disclosure framework that would require truly expansive disclosures.

Details about how a company manages climate risks (day-to-day, and broad strategy)

Company-level metrics, such as financial impacts of climate change and progress toward internal climate goals

Disclosure of greenhouse gas emissions, directly and by entire “value chain”

Describe how climate change could affect business in the future

Forward-looking statements that address climate change regulations, and transitioning to a net-zero emissions business model

Industry-specific ESG metrics for banks

troutman pepper

Environmental, Social and Governance (ESG) Initiatives

<u>Materiality</u> poses a major challenge. Much ESG information will not be material to a company as a whole, applying traditional definitions.

In response, some ESG investors and climate activists are pushing the SEC to make a blanket assumption that all potential ESG-related disclosures are material.

Similar language in legislation approved by the U.S. House: "*It is the sense of Congress that ESG metrics, as such term is defined by the Commission … are <u>de facto material</u> for the purpose of disclosures.*"

This would have <u>*SIGNIFICANT*</u> impacts:

→ Fundamental change to SEC's approach to disclosure, and materiality as a guiding principle.

→ Currently, SEC does not have authority to address ESG issues to promote goals unrelated to the federal securities laws.

troutman pepper

Environmental, Social and Governance (ESG) Initiatives

Now is the time to focus on ESG.

Potential action items:

- → Affirm Board responsibility for ESG matters and assign Board committee responsibility
- → Begin integrating ESG into the company’s strategic planning process and ERM framework
- → Collect and verify data from within and outside company that is needed to measure ESG matters and risks, provide accurate disclosures, and support informed decision-making
- → Begin communicating with important ESG audiences and stakeholders
- → Hire qualified outside experts to assist the company in preparing an ESG strategic plan, and executing on that plan

Environmental, Social and Governance (ESG) Initiatives

troutman pepper

Environmental, Social, and Governance (ESG)

EXPERIENCE > PRACTICES > CAPITAL PROJECTS AND INFRASTRUCTURE > ENVIRONMENTAL, SOCIAL, AND GOVERNANCE

Businesses across a range of industries—from start-up, to stand-out—are increasingly turning to Troutman Pepper for advice on the myriad of business and legal implications connected with Environmental, Social, and Governance (ESG). Troutman Pepper attorneys closely track Securities Exchange Commission (SEC) and Federal Trade Commission regulations and policies relating to ESG to better advise clients on reporting requirements and their implications. We also understand that ESG is not just driven by regulatory requirements, but also by the demands of client's stakeholders, including shareholders, customers, employees, suppliers, and communities. We understand these drivers and can help develop strategies for enacting policies and programs to implement ESG strategies.

We help these businesses grow by bringing our experience to every aspect of their ESG initiatives, including environmental management;

CONTACTS

Craig M. Kline
Partner
Email
212.704.6150

John J. Leonti
Partner
Email
213.928.9873

Annette Michelle (Shelli) Willis
Partner
Email
404.885.3388

Link: [Environmental, Social, and Governance | Troutman Pepper]

Environmental, Social and Governance (ESG) Initiatives

Troutman Pepper Achieves National Recognition for ESG Practice

Reuters Legal Features Firm's Response to Fictitious Sustainability Scenario

08.04.21

NEW YORK –Troutman Pepper is featured in *Reuters Legal* for being among the top four law firms that responded to a manufactured scenario involving environmental, social and governance (ESG) issues.

Earlier this year, the national news outlet put together a panel of sustainability experts who created a fictitious tractor company that needed help in its ESG strategy. In June, *Reuters* invited Troutman Pepper and other top law firms to make recommendations to the fake company. Eighteen firms responded, and Troutman Pepper was one of four law firms that "really stood out to panelists."

Related Professionals

David I. Meyers

Annette Michelle (Shelli) Willis

Andrea W. Wortzel

Related Practices and Industries

Environmental, Social, and Governance (ESG)

Sustainability and Product Stewardship

Related Offices

Richmond

Atlanta