SEC's disclosure effectiveness initiative reshapes MD&A disclosure requirements

Richard J. Parrino

Richard J. Parrino (richard.parrino@hoganlovells.com) is a partner in the Washington, District of Columbia, USA office of Hogan Lovells US LLP.

Abstract

Purpose – *This article examines rule amendments issued by the US Securities and Exchange Commission in November 2020, as part of the SEC's ongoing ''disclosure effectiveness initiative'', that revise in significant respects the requirements for financial disclosures presented in SEC filings as Management's Discussion and Analysis of Financial Condition and Results of Operations.*

Design/methodology/approach – *This article provides an in-depth analysis of the rule amendments in the context of contrasting perspectives expressed by the SEC, individual SEC Commissioners who dissented from adoption of the amendments, and market participants regarding the merits of the SEC's movement away from prescriptive disclosure requirements towards a more principles-based approach to disclosure.*

Findings – *Although the SEC's rules have long reflected a mix of principles-based and prescriptive disclosure elements, the principles-based emphasis in this latest stage of the SEC's disclosure modernization project accords the managements of filing companies greater latitude to determine whether financial information is material to investors and how such information should be presented.*

Originality/value – *This article provides expert guidance on a major new SEC disclosure development from an experienced securities lawyer.*

Keywords *Materiality, US Securities and Exchange Commission (SEC), Prescriptive disclosure, Principles-based disclosure, Regulation S-K, Management's Discussion and Analysis (MD&A)*

Paper type *Technical paper*

The US Securities and Exchange Commission (SEC) has been engaged since 2016 in a "disclosure effectiveness initiative" to modernize the disclosure that companies must provide to investors in their SEC filings [1]. The promotion of effective disclosure is at the center of the SEC's mission and has generated a long list of rulemakings over the decades. Today the SEC also is responding to mandates from the US Congress to update the current disclosure regime to reduce compliance costs and burdens for filing companies [2]. In accordance with the legislative directives, the SEC has amended many of its rules to streamline existing requirements, improve the readability and navigability of disclosure, and discourage repetition and disclosure of information that is not material to investors. The rulemaking process has exposed disagreements within the ranks of the agency's Commissioners and among market participants about how best to simplify compliance for companies while improving information provided to investors within a revised disclosure framework.

The SEC recently has extended its reform project to core financial disclosures presented in registration statements, reports, and other information filed with the agency. The centerpiece of the disclosures is the filing company's commentary on its financial performance and prospects presented as "Management's Discussion and Analysis of Financial Condition and Results of Operations" (known in short as "MD&A" or "management's discussion"). The rules governing MD&A and associated disclosures constitute part of Regulation S-K, which is the repository for a common set of informational

© Hogan Lovells 2021. All rights reserved. This publication is for information only. It is not intended to create, and receipt of it does not constitute, a lawyer-client relationship.

requirements prescribed for filings under the US Securities Act of 1933 (Securities Act) and the US Securities Exchange Act of 1934 (Exchange Act) [3].

The SEC issued significant amendments to the disclosure requirements for MD&A in November 2020 [4]. The amendments to Item 303 of Regulation S-K, which specifies the requirements for management's discussion, and related interpretive guidance continue the SEC's decades-long effort to elicit improved MD&A disclosure and build on major guidance previously issued by the SEC.

The amended rules, which became effective in February 2021, and new guidance will require companies to augment, revise, or restructure their management's discussion. The SEC has updated its rules and guidance on a variety of MD&A topics – including capital resources disclosure and analysis of the impact of known trends or uncertainties on operations – that will warrant a critical review of historical presentations. The SEC also has eliminated some line-item disclosures and directed companies to discuss the affected matters in a materiality-focused disclosure tailored to their particular businesses and circumstances. The amendments modify corresponding disclosure requirements that apply to non-US companies subject to SEC disclosure requirements that are classified as "foreign private issuers" under the SEC's rules [5].

Regulatory considerations in disclosure reform

The rulemaking process on updating MD&A disclosure has revealed contrasting perspectives on effective disclosure principles. The debate has concentrated on whether changes to existing disclosure should be based on a "principles-based" approach or a "prescriptive" approach. The SEC itself is divided on this question, which contributed to the decision of two of the agency's five Commissioners to dissent from adoption of the MD&A amendments. The contention over this subject has focused on the operation of the "materiality" doctrine that is foundational to the US securities laws and SEC regulation.

Principles-based versus prescriptive disclosure. Regulation S-K has long reflected a mix of principles-based and prescriptive disclosure elements. In its disclosure effectiveness initiative, including the MD&A amendments discussed below, the SEC has moved towards a more principles-based disclosure approach [6].

As discussed by the SEC in its rule releases on disclosure reform, prescriptive (or "line item") disclosure requirements use bright-line, quantitative, or other thresholds to identify required disclosure, or enumerate mandatory disclosure topics that direct companies to disclose the same type of information. Under the prescriptive approach, the SEC thus requires topic-specific disclosures based on its judgment that the required information is or could be material, or otherwise may be important to investors [7].

Principles-based rules, by contrast, largely shift the materiality determination from the SEC to the company preparing the disclosure document. Under this approach, the company's management is required to evaluate the significance of information in the context of the company's particular business and financial circumstances, and to determine whether disclosure of the information is necessary in light of established principles of materiality and how to present any such disclosure.

The SEC has favored a principles-based approach to many of its rule revisions. In a view supported by many companies on the rule proposals, the SEC believes that principles-based disclosure should enable a company to provide investors with better disclosure tailored to its particular circumstances and to reduce disclosure that is immaterial, irrelevant, or outdated. The SEC has adopted a number of techniques in reframing selected rules along these lines. One of the most common is to eliminate mandatory disclosures and substitute a non-exclusive list of disclosure topics which – together with related matters

considered relevant by the company – the rule indicates must be disclosed only to the extent material to an understanding of the company's business or performance.

In commenting on the SEC's proposals for amendments to the MD&A requirements and other rules, some investors have opposed principles-based disclosure on the grounds that it would give management too much leeway in deciding whether information is material and in determining how to present information considered material [8]. This concern is grounded in skepticism that investors can rely on managers to make appropriate materiality determinations. In a speech delivered in May 2021, SEC Commissioner Allison Herren Lee concurred in the view that "management frequently sees things differently from investors", whether because managers employ higher materiality thresholds or because managers' belief in the nature and direction of their businesses may lead them to consider as positive or temporary particular financial results or trends that investors might see as negative developments [9].

The SEC has conceded in releases for the rule revisions that, without specific disclosure guidelines, some companies may "misjudge what information is material". The SEC added, however, that it expects that this risk will be mitigated by the operation of the company's internal controls, board oversight of the disclosure process, the SEC staff's filing review program, the company's engagement with investors, and the application of the antifraud provisions of the securities laws, which afford investors a basis to obtain redress for harm suffered as result of materially deficient disclosures [10].

Some investors also have objected that the elimination of disclosure benchmarks applicable to all companies would reduce the comparability of disclosures across companies and industries, because companies can be expected to interpret and apply the principles differently in the absence of clear guidelines. The SEC has acknowledged that less comparability might be one cost of a principles-based disclosure approach, but has suggested that in some cases investors may place too much weight on comparisons that are unwarranted in the light of differences among companies [11].

Materiality determinations. Information generally is disclosable under the US securities laws and SEC rules if the information is "material" and there is a duty to disclose it. A company filing a registration statement or report with the SEC has a duty to disclose particular information if the applicable rules in Regulation S-K require disclosure of the information. In the shift to principles-based rules, disclosure decisions increasingly will turn on the company's materiality determinations.

In its rule releases, the SEC has recited the test for materiality as defined in US Supreme Court jurisprudence. Under the Supreme Court's test, information is material to a company if there is a "substantial likelihood" that a "reasonable investor" would consider the information important in deciding whether to buy or sell the company's securities. To fulfill the materiality requirement, there must be a substantial likelihood that a reasonable investor would view the information as having "significantly" altered the "total mix" of information made available [12]. The SEC rules defining materiality for disclosures under the Securities Act and the Exchange Act reflect the Supreme Court's materiality test [13].

Materiality determinations under the "reasonable investor" standard require a consideration of all relevant facts and circumstances. This context-specific approach should take account of both qualitative and quantitative factors. Further, deciding that a specific item of Regulation S-K requires a particular disclosure does not end the company's assessment of the scope of disclosure it must provide. The company also must consider the parallel directives of Rule 408(a) under the Securities Act and Rule 12 b-20 under the Exchange Act to disclose, in addition to any specifically required information, "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading". The same principle underlies the antifraud provisions of the US securities laws.

The SEC's principles-based disclosure approach considers that companies are suited to conduct the fact-specific consideration needed to determine what information is material to an understanding of their businesses by investors. This view, however, is not held by all of the SEC's Commissioners. Commissioner Lee, who dissented from adoption of the MD&A amendments, has expressed the view that a "disclosure system that lacks sufficient specificity and relies too heavily on a broad-based concept of materiality will fall short of eliciting information material to reasonable investors" [14].

Important themes for management's discussion

The SEC adopted the latest MD&A amendments against the backdrop of regulatory efforts, pursued since the SEC adopted the present form of MD&A disclosure requirements in 1980, to encourage companies and their managements provide more meaningful disclosure. Two of the most important SEC pronouncements on MD&A took the form of interpretive advice that the agency presented in releases issued in 1989 and 2003 [15]. The SEC reiterated in its 2020 rule release many of the themes it had emphasized in the earlier statements. The SEC consistently has highlighted four major themes related to the preparation of management's discussion.

The first theme is that the purpose of MD&A is to enable a reader to see the company's business through the eyes of its management. Management's discussion should address economic or industry-wide factors relevant to the company, inform the reader about how the company earns revenue and income and generates cash, and provide insight into the short-term and long-term material opportunities, challenges, and risks faced by the company and the company's business plan for responding to those opportunities, challenges, and risks.

Second, the SEC has emphasized that management's discussion should be materiality-based and focus the disclosure on key variables affecting the company's financial condition and operating results. The SEC has prodded companies to pare from MD&A unnecessary detail and redundant, irrelevant, or stale disclosure that obscures material information.

Third, the SEC has taken aim at disclosures that merely represent a restatement of changes in financial statement line items, reminding companies that management's discussion requires an *analysis* as well as a discussion of the disclosure elements. Companies should include in MD&A a thorough analysis of known material trends, events, demands, commitments, and uncertainties, explaining the underlying reasons or implications, the relationships among constituent elements, and the relevant significance of those matters.

Fourth, the SEC has underscored that material forward-looking information relating to known material trends and uncertainties represents required, not optional, disclosure.

MD&A amendments

The SEC's amendments to Item 303 of Regulation S-K update MD&A requirements for US companies. The SEC also has adopted corresponding amendments to disclosure required by Form 40-F for Canadian companies and Form 20-F for other foreign private issuers.

Objective of MD&A. The amendments add a new Item 303(a) captioned "Objective" which identifies the principal objectives of MD&A. The SEC explains that this statement of objectives, which largely incorporates instructions to prior Item 303(a), is "intended to provide clarity and focus to companies as they consider what information to discuss and analyze". In the SEC's view, the item does not change the prior scope of management's discussion, although it expressly integrates references to "cash flows" into the description of aspects of financial condition management should address.

New Item 303(a) calls for companies to disclose in MD&A:

- material information relevant to an assessment of the company's financial condition and results of operations, including an evaluation of the amounts and certainty of cash flows from operations and outside sources;
- material events and uncertainties known to management that are "reasonably likely" to cause reported financial information not to be indicative of future operating results or of future financial condition, including (1) descriptions and amounts of matters that have had a material impact on reported operations and (2) matters that are reasonably likely, based on "management's assessment", to have a material impact on future operations; and
- material financial and other statistical data that the company believes will enhance a reader's understanding of the company's financial condition, cash flows and other changes in financial condition, and results of operations.

The SEC underlines that these objectives:

- "provide the overarching requirements of MD&A and apply throughout amended Item 303";
- "emphasize a company's future prospects", which should be addressed as well as the company's short-term results, and "the importance of materiality and trend disclosures to a thoughtful MD&A"; and
- expressly incorporate the SEC's long-time guidance that MD&A is intended to provide disclosures from "management's perspective".

The SEC declares that MD&A's "materiality-focused and principles-based approach" provides a surer basis for sound financial disclosure than a list of specific requirements that may not be applicable to particular companies or may become outdated. For this reason, the SEC did not accept the suggestion of some commenters on the proposed amendments that it add to the statement examples of the types of matters companies should discuss in MD&A [16].

Management's discussion and analysis of liquidity and capital resources. In updating the required discussion and analysis of liquidity and capital resources, the SEC eliminated some line-item requirements for disclosure of specific financial information in favor of an approach that requires companies to integrate the information into a broader, principles-based presentation.

Disclosure of material cash requirements

Former Item 303(a)(2) required a company to discuss its material commitments for capital expenditures as of the end of the latest fiscal period, and to indicate the general purpose and anticipated sources of funds needed to fulfill the commitments. The company also was required to discuss, among other factors, any known favorable or unfavorable trends in its capital resources, and indicate any expected changes in the mix and relative cost of such resources.

The amendments clarify that the capital resources disclosure extends beyond a description of commitments for capital expenditures and other capital investments and should encompass all "material cash requirements".

Amended Item 303(b)(1)(ii) accordingly requires the company to describe (1) its "material cash requirements", including commitments for capital expenditures, as of the end of the latest fiscal period, (2) the anticipated source of funds needed to satisfy such cash requirements, and (3) the general purpose of the requirements. The SEC notes that, for some companies, investments in property, plant, and equipment do not constitute a material demand on capital resources. Those companies instead may deploy their capital

resources to meet cash needs that do not involve capital investments, such as investments in intellectual property or human resources.

In its release the SEC makes the following observations in addressing comments on this aspect of the amendments:

- the reference to "requirements" rather than "capital commitments" is consistent with prior SEC guidance and market practice with respect to the scope of this disclosure, and therefore is not intended to require companies "to deviate substantially from current practices with respect to an assessment of material cash requirements";
- the focus of this disclosure is on cash requirements that are material to the company and accordingly "do not reflect a new threshold for these disclosures and should not require extensive or new procedures or controls"; and
- the disclosure requirement is intended to capture material cash requirements related to the normal course of operations as well as cash requirements outside of normal operations.

The cash requirements disclosure is part of the SEC's effort, discussed below, to enhance the discussion of liquidity and capital resources [17].

Liquidity and capital resources disclosures

Amended Item 303(b)(1) clarifies essential elements of the required principles-based discussion by each company of its liquidity and capital resources needs.

Disclosure framework. The framework for disclosure of liquidity and capital resources under amended Item 303(b)(1) requires the company to:

- address its "liquidity", which the item defines as a "company's ability to generate and obtain adequate amounts of cash to meet its requirements" for cash;
- discuss both (1) its short-term liquidity and capital resources needs for the period up to 12 months from the most recent fiscal period presented and (2) its long-term liquidity and capital resources for the period beyond 12 months; and
- analyze its material cash requirements from known contractual and other obligations and specify the type of obligations and the relevant time period for the related cash requirements.

The SEC confirms that companies have the flexibility either to combine their discussion of liquidity with their discussion of capital resources, or to present the two topics separately.

Disclosure of known contractual and other obligations. The amendments eliminate the requirement under prior Item 303(a)(5) for companies (other than smaller reporting companies) to disclose in a tabular format their known contractual obligations. The amended item instead specifically requires companies to disclose in the liquidity and capital resources discussion their material cash requirements from known contractual and other obligations, some of which currently appear in the contractual obligations table.

The SEC provides the following guidance on the principles-based discussion of material cash requirements from known contractual and other obligations that will replace the tabular presentation:

- unlike the contractual obligations table, which did not have a materiality threshold, the focus of discussion under the revised item is on disclosure of those obligations and time periods (1) that involve material cash requirements or (2) where the reasonably likely effect of the obligations on liquidity or capital resources is material; and

- although the item provides examples of known contractual obligations – including lease obligations, purchase obligations, and other liabilities reflected on the company's balance sheet – that may be subject to disclosure, it does not prescribe specific categories of contractual obligations, or specify or provide examples of "other obligations", thereby affording the company flexibility in each case to determine which obligations may be material and required to be disclosed [18].

Off-balance sheet arrangements. The amendments replace the current specific requirements to disclose all material off-balance sheet arrangements with a "principles-based instruction" addressing disclosure of these arrangements. The amendments:

- eliminate the specific disclosure requirements for material off-balance sheet arrangements in prior Item 303(a)(4);
- eliminate the prior requirement to present disclosure of those arrangements in a separately captioned section of management's discussion, although the SEC indicates that companies have the discretion to retain a caption if they believe it will assist investor understanding;
- add an instruction to Item 303(b) requiring the company to discuss commitments or obligations – including contingent obligations – arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements, or capital resources; and
- replace the definition of "off-balance sheet arrangements" in the prior item with what apparently is intended as a non-exclusive list of the types of arrangements that could be covered by the new instruction.

The SEC expects companies to incorporate their discussion of material off-balance sheet arrangements into their broader discussion of liquidity and capital resources, which will require "a discussion of material matters of liquidity, capital resources, and financial condition as they relate to off-balance sheet arrangements". The SEC decided not to provide examples or guidance for this disclosure, since it believes that, consistent with a principles-based approach, the disclosure should be tailored to a company's particular circumstances. The SEC notes that, under this approach, companies should consider whether to discuss certain types of balance-sheet arrangements that do not fall within the prior definition of "off-balance sheet arrangements", such as certain types of contingent milestone payments [19].

Management's discussion and analysis of results of operations. The amendments re-caption prior Item 303(a) as Item 303(b), which, as amended, continues to apply to all MD&A disclosures. Items 303(b) and 303(c) have been amended to address specific elements of management's discussion and analysis of results of operations for full fiscal years and interim periods.

Disclosure of known trends or uncertainties and known events

The amendments build on existing SEC guidance to define the approach a company should take in identifying and discussing the impact of known trends or uncertainties and known events on its results of operations.

Amended Item 303(b)(2)(ii) provides that a company must disclose any known trends or uncertainties that are "reasonably likely" to have a material impact (favorable or unfavorable) on net income, revenues, or income from continuing operations, rather than, as under the prior rule, known trends or uncertainties which the company "reasonably expects"

will have such an impact. Similarly, the amended item states that a company must disclose known events which are “reasonably likely to cause” a material change in the relationship between costs and revenues, rather than, as under the prior rule, known events that “will cause” such a change.

The SEC has adopted the following approach to determining the need for and scope of this disclosure:

“*Reasonably likely” disclosure threshold*. The “reasonably likely” standard will serve, in the SEC’s formulation, as “a consistent threshold for forward-looking disclosure throughout MD&A”. The MD&A objectives identified in new Item 303(a) indicate that whether a material trend, uncertainty, or event known to management is reasonably likely to have a material impact on future operations is based on “management’s assessment”.

Test for disclosure of known trends, demands, commitments, events, or uncertainties. The SEC articulates in its release a “two-step test” for applying the “reasonably likely” standard for analysis and disclosure of a known trend, demand, commitment, event, or uncertainty (trend or uncertainty). The test is based on guidance presented in the SEC’s 1989 interpretive release on MD&A.

In the first part of the test:

- the company should consider whether a known trend or uncertainty is “likely to come to fruition”; and
- if the company determines that the trend or uncertainty is likely to come to fruition, it should provide appropriate disclosure if the known trend or uncertainty would “reasonably be likely to have a material effect” on the company’s future results or financial condition.

Applying the second part of the test, disclosure also would be required with respect to the impact of a known trend or uncertainty:

- if the trend or uncertainty is “not remote” *or* if management cannot make an assessment as to the likelihood that it will come to fruition; *and*
- the trend or uncertainty would “reasonably be likely to have a material effect” on the company’s future results or financial condition if it came to fruition *and* a “reasonable investor would consider omission of the information as significantly altering the mix of information made available in the company’s disclosures” [20].

The SEC elaborates in the release on the following aspects of the two-step test in response to comments on the proposed amendments suggesting that the test “is unclear, not well understood, or difficult to apply”.

Likelihood of occurrence: The determination of whether a future trend or uncertainty is likely to come to fruition should be made “objectively”, in accordance with the SEC’s position that the test generally “should be based on objective reasonableness”. The focus of the test, therefore, is “on an objective determination of the likelihood of an event occurring, rather than on whether management’s expectation of such event occurring would be objectively reasonable” [21].

Materiality determination: The analysis does not call for disclosure of immaterial events. Instead, it should focus on material information based on concepts of materiality articulated by the US Supreme Court and echoed in the SEC’s rules. Applying those materiality principles:

- disclosure of a known trend or uncertainty must be guided by a consideration of what “would be considered important by a reasonable investor in making a voting or investment decision”;
- the “reasonably likely” threshold does not require disclosure of a known trend or uncertainty for which fruition may be “remote”;

- the "reasonably likely" threshold does not set a "bright-line percentage threshold" by which disclosure would be triggered; and
- the analysis does not require companies "to affirm the non-existence or non-occurrence of a material future event" [22].

Consistent with the guidance it issued in 1989, the SEC decided not to import into this analysis the probability/magnitude test for materiality announced by the US Supreme Court in its *Basic Inc. v. Levinson* decision. Under that test, the Supreme Court said that the materiality of forward-looking disclosure depends on a balancing of both "the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity". The SEC concluded that this test, which was focused on the materiality of a potential merger transaction, is ill-suited for management's discussion since it could result in the disclosure of a known trend or uncertainty that is large in magnitude but low in probability [23].

Quarterly period discussion

The SEC has amended Item 303 to provide companies with additional flexibility in presenting *quarterly* period-to-period comparisons of their results of operations. The amendments leave in place the prior requirement that a company also provide *year-to-date* comparative information on operating results, which covers the first six months of the current and prior fiscal years in the second quarter Form 10-Q report and the nine-month periods of the two years in the third quarter Form 10-Q report.

Amended Item 303(c)(2)(ii) permits companies to compare their operating results for their most recent quarter to either (1) the results for the corresponding quarter of the prior year (as long required) *or* (2) the results for the immediately preceding quarter. The SEC believes that, because not all businesses are seasonal, a comparison of operating results with the corresponding quarter of the prior year may not be as meaningful as a comparison of results to the preceding quarter.

If a company chooses to discuss changes from results for the immediately preceding quarter, it must provide in the filing the summary financial information that is the subject of the discussion for the immediately preceding quarter, or identify the prior filing under the SEC's EDGAR filing system that presents this information, so that a reader may have ready access to the prior-quarter financial information being discussed.

If in a subsequent Form 10-Q report the company changes the comparison from the comparison presented in the immediately preceding Form 10-Q report, it will be required to explain the reason for the change and present both comparisons in the filing where it discloses the change. The SEC expects that this disclosure will afford investors greater insight into a company's decision-making and provide a basis for them to understand any period-over-period change in presentation [24].

Discussion of period-to-period changes

Amended Item 303(b) states that, in providing a narrative discussion of material period-to-period changes in one or more financial statement line items, the company should discuss the "reasons underlying" the changes rather than only the "causes" for the changes. The SEC intends by this change to encourage companies to provide a "more meaningful" discussion of the factors contributing to the line-item changes.

The SEC emphasizes that, consistent with its long-time guidance, the discussion of the reasons for material changes should be presented in qualitative as well as quantitative terms. The SEC refers to a prior instruction, carried over to amended Item 303(b), to remind companies that they will not provide sufficient *analysis* of material changes in line items if

they simply “recite the amounts of changes from period to period” based on numerical data contained in or computable from the financial statements.

The amended item also provides that disclosure is required where material period-to-period changes within a line item offset each other [25].

Discussion of operating information for subdivisions

Prior Item 303(a) required the company to discuss operating information for each reportable segment or other “subdivision” of the business (such as geographic areas) if in the company’s judgment the information would be appropriate to an understanding of its business. In moving this requirement to amended Item 303(b), the SEC has identified “product lines” as an example of a subdivision of a company’s business the company may discuss in accordance with this direction. The SEC cautions that the addition of this reference is not intended to require product-line disclosure if, in the company’s judgment, such a disclosure is not necessary to understand its business [26].

Inflation and price changes

Amendments to prior Item 303(a)(3)(iv) and prior instructions to Item 303(a) eliminate the requirement to describe the impact of inflation and price changes on the company’s net sales, revenue, and income from continuing operations to the extent material. The SEC points out that companies should discuss the impact of inflation and price changes if they are part of a known trend or uncertainty that had, or is reasonably likely to have, a material impact on any of these line items, and also may have to address the effect of the factors as part of the general requirement in amended Item 303(b) to discuss material period-to-period changes in quantitative and qualitative terms [27].

Conclusion

The SEC’s adopting release both describes the rule amendments and provides updated interpretive guidance on how to prepare management’s discussion. The release highlights many of the same themes that have appeared in the SEC’s guidance on MD&A published in 1989 and 2003 and as part of the SEC’s broader, continuing overhaul of Regulation S-K aimed at modernizing and enhancing disclosure effectiveness.

In this latest pronouncement, the SEC emphasizes the importance of presenting the different elements of MD&A within an integrated principles-based disclosure framework. The release also underscores the SEC’s current views on the objectives of MD&A and on what it considers deficient disclosure practices. The release reinforces the SEC’s call for MD&A to present a clear, well-organized discussion and analysis that focuses on material information and provides management’s perspective on the company’s business.

The concept of materiality will continue to play the central role in disclosure decisions. Many of the new disclosures will be anchored in management’s determinations concerning what information is material to an understanding of the company’s business. The amendments relating to liquidity and capital resources in particular provide greater scope for management’s materiality determinations by eliminating some mandatory disclosures that have served as a checklist for companies’ use in identifying potentially material information and organizing this part of management’s discussion. The enhanced principles-based approach, by contrast, provides fewer sign posts for structuring the disclosure.

It will require a substantial effort for many companies to revise their current MD&A to respond to the amendments and address the lessons of the SEC’s guidance. In reviewing its current MD&A in light of the amendments and the SEC’s updated guidance, each company should:

- *Take a fresh look at MD&A*: The company should revise its current presentation to comply with the new requirements and reflect the SEC's latest guidance. Even if the overall presentation and focus of its MD&A are sound, the company should critically review the individual components of MD&A to identify potential areas for improvement.
- *Involve senior management in preparing MD&A*: MD&A must extend beyond a review of financial measures to encompass a discussion and analysis of all of the most important matters on which management focuses in evaluating the company's business. The SEC encourages early top-level involvement by a company's management in identifying the key disclosure themes and ideas. Management's participation is particularly important given the central role of materiality assessments in the principles-focused approach of MD&A.
- *Devote sufficient time to MD&A*: The company should begin the MD&A review and drafting process at an early enough date to provide the corporate reporting team and any outside advisers sufficient time to prepare an MD&A that complies with the new requirements and that is responsive to the SEC's new guidance.

The SEC recognizes the effort that will be required to provide disclosure under a principles-based regime that is relevant to the company's specific context. In commenting on the expected costs of preparing such disclosure, the SEC observed that the former rules under Regulation S-K "may be easier to apply" than the new principles-based requirements, as prescriptive-based requirements "involve fewer judgments" [28]. The increased latitude accorded to management in structuring the presentation of information to investors could require re-examination of many disclosures that might not have received special attention for some time.

Notes

1. The SEC has stated that the overall objective of this initiative is to improve its disclosure regime for both investors and registrants. See SEC Spotlight on Disclosure Effectiveness, available at https://www.sec.gov/spotlight/disclosure-effectiveness.shtml. A summary of the genesis and major milestones of the initiative is presented by the SEC in Modernization of Regulation S-K Items 101, 103, and 105, Release No. 33-10825 (Aug. 26, 2020) (Modernization Rule Release), § I.
2. In the lead-up to the current initiative, the SEC staff issued a study in December 2013 called "Report of Review of Disclosure Requirements in Regulation S-K", which it prepared pursuant to a provision in the Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, Sec. 108, 126 Stat. 306 (2012), directing the SEC to conduct a review of Regulation S-K to determine how those disclosure requirements can be updated to modernize and simplify the registration process for a smaller class of companies classified as "emerging growth companies" under the SEC's rules. The SEC subsequently amended provisions of Regulation S-K pursuant to a mandate in the 2015 Fixing America's Surface Transportation Act (FAST Act), Pub. L. 114-34, Sec. 72003, 129 Stat. 1312 (2015) to simplify disclosure compliance for filing companies generally. See FAST Act Modernization and Simplification of Regulation S-K, Release No. 33-10618 (Mar. 20, 2019), § I.
3. 17 CFR Part 229.
4. The SEC's adopting release for the MD&A amendments is Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Release No. 33-10890 (Nov. 19, 2020) (MD&A Release). Together with the MD&A amendments, the SEC eliminated Item 301 of Regulation S-K, which required disclosure of five years of selected financial data by most filing companies. The SEC also significantly curtailed the scope of Item 302, which required disclosure of selected quarterly financial data, replacing the former requirement for quarterly tabular disclosure with a principles-based requirement for disclosure of material retrospective changes.
5. See Rule 405 under the Securities Act.
6. The SEC refers to the varying perspectives on the two approaches in each of the adopting releases describing the Regulation S-K amendments. For a convenient summary by the SEC of the major points of the debate, see the section captioned "Principles-Based versus Prescriptive Requirements" in the Modernization Rule Release, § IV.B.1.

7. SEC Commissioner Lee observes in a speech delivered on May 24, 2021 that the statutory rulemaking authority of the SEC under the Securities Act does not limit the agency to requiring disclosure of material information; rather, the SEC may require disclosures that are in the public interest and for the protection of investors without reference to materiality. Commissioner Allison Herren Lee, "Living in a Material World: Myths and Misconceptions about Materiality", available at https://www.sec.gov/news/speech/lee-living-material-world-052421
8. See note 6 *supra*.
9. See note 7 *supra*.
10. See note 6 *supra*.
11. See note 6 *supra*.
12. See *TSC Industries, Inc. v. Northway*, 426 U.S. 438, 449 (1977); *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988).
13. Rule 405 under the Securities Act; Rule 12b-2 under the Exchange Act. See MD&A Release, § II.C., at p. 46 n.159.
14. See note 7 *supra*.
15. See SEC Interpretations: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release No. 33-6835 (May 18, 1989); Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003).
16. MD&A Release, § II.C.1.a.
17. MD&A Release, § II.C.2.
18. MD&A Release, § II.C.7.
19. MD&A Release, § II.C.6.
20. MD&A Release, § II.C.3.
21. See note 20 *supra*.
22. See note 20 *supra*.
23. See note 20 *supra*.
24. MD&A Release, § II.C.9.
25. MD&A Release, § II.C.1.b.
26. MD&A Release, § II.C.1.c.
27. MD&A Release, § II.C.5.
28. See Modernization Rule Release, § IV.B.1.

Corresponding author

Richard J. Parrino can be contacted at: richard.parrino@hoganlovells.com

For instructions on how to order reprints of this article, please visit our website:
www.emeraldgrouppublishing.com/licensing/reprints.htm
Or contact us for further details: permissions@emeraldinsight.com