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U.S. CAPITAL MARKETS

Less is more: SEC works to simplify disclosure and other U.S. developments

In 2019, the U.S. Securities and Exchange Commission (SEC) continued working to simplify public company disclosure requirements, broadened the popular "test-the-waters" rules for emerging growth companies to make them available to all companies and focused attention on the prominent role of proxy advisory firms in the U.S. proxy process.

Rolling with the times – SEC moves to modernize and simplify disclosure requirements

In March, the SEC took steps to modernize and simplify the disclosure requirements for registration statements and periodic reports, with new rules becoming effective in May. The changes were aimed at reducing compliance costs for public companies, providing more useful and less repetitive information to investors and curbing some requirements to include non-material information.

Notable changes include

- **Confidential treatment process:** Registrants may now redact confidential information in material contracts filed as exhibits to registration statements and periodic reports, provided that the redacted information is not material and would likely cause competitive harm to the registrant if publicly disclosed, without having to first submit a confidential treatment request to the SEC for review and approval.
- **Exhibit requirements:** Registrants may now omit immaterial schedules and attachments from all filed exhibits, rather than only from exhibits that are material acquisition or reorganization agreements.
- **MD&A disclosure:** In periodic reports, registrants may now omit from discussion in their MD&A the earliest of the three fiscal years covered by the financial statements included in the periodic report, if any prior filings with the SEC already contained a discussion of that year and the discussion of that year is not necessary for investors to understand the registrant's current financial condition.
- **Physical property descriptions:** The requirement to describe physical properties now only requires disclosure of physical properties that are material to the registrant, and no longer requires disclosure of properties that are not material to the registrant.

In August, the SEC also announced proposed amendments to modernize the business, legal proceedings and risk factor disclosure requirements in Regulation S-K, which is the regulation that prescribes most of the SEC disclosure requirements applicable to U.S. domestic registrants.

The SEC is proposing amendments to the disclosure requirements regarding the general development and description of the registrant's business:

- **Principles-based disclosure:** Instead of prescribing specific "line item" disclosure points, the new requirements would be based on the principle that a registrant should disclose information that is material to an understanding of the general development of a registrant's business. The rules would provide examples of the types of information that may be appropriate to disclose (including material changes to a previously disclosed business strategy), but not be limited to those examples or require that disclosure be provided regarding any of the examples that are not actually material to the registrant.
- **Focus disclosure on developments:** In filings made after a registrant's initial filing, the registrant may provide only an update of the general development of its business that focuses on material developments during the reporting period, with an active hyperlink to the registrant's most recent filing that, read together with the update, will provide a full discussion of the general development of the registrant's business.

Disclosure requirements for legal proceedings would be simplified and modernized by

- allowing required information about material legal proceedings to be provided by including hyperlinks or cross-references to legal proceedings disclosure located elsewhere in the document in order to avoid duplicative disclosure

- revising the US$100,000 threshold for disclosure of environmental proceedings involving the registrant to which the government is a party to US$300,000 to adjust for inflation

Risk factor disclosure requirements would be revised by

- providing guidance discouraging the inclusion of generic risk factors and requiring summary risk factor disclosure at the beginning of the risk factors section if that section exceeds 15 pages
- refining the principles-based approach to risk factor disclosure by changing the disclosure standard from the "most significant" factors to the "material" factors required to be disclosed
- requiring risk factors to be organized under relevant headings, with any risk factors that may generally apply to an investment in securities being disclosed at the end of the risk factor section under a separate caption

Corresponding changes would also be made to corresponding items in Form 20-F, which is the form of annual report used by non-MJDS companies qualifying as foreign private issuers.

Generally, the adopted and proposed changes will not have a significant impact on Canadian registrants using MJDS because those companies are primarily subject to prescribed disclosure requirements under Canadian securities laws instead of Regulation S-K or Form 20-F. However, the adopted and proposed changes have applicability to Canadian registrants that report on U.S. domestic forms (such as annual reports on Form 10-K and quarterly reports on Form 10-Q) or that file annual reports on Form 20-F.

The changes will not have a significant impact on Canadian registrants using MJDS and primarily affect Canadian registrants that report on U.S. domestic forms or that file annual reports on Form 20-F.

It's okay to M&A – SEC proposes to ease disclosure requirements relating to business acquisitions and dispositions

In May, the SEC proposed amendments to the financial statement disclosure requirements for business acquisitions and dispositions.

Among the significant proposed changes to these rules are amendments

- reducing the maximum period for which historical annual audited financial statements for an acquired business are required, depending on significance, from three fiscal years to two fiscal years (eliminating the current requirement to include three years of historical financial statements of the target for an acquisition that exceeds 50% significance)
- eliminating the requirement for financial statements of an acquired business to be separately presented once the results of the acquired business have been reflected in the acquiring company's audited financial statements for a complete fiscal year, regardless of the significance of the acquisition
- revising the "investment" test and "income" test used to determine the significance of an acquisition or disposition to more closely align with the actual economic significance of the transaction to the registrant and expanding the use of filed pro forma financial information when measuring significance

- increasing the threshold under the significance tests for dispositions to only require pro forma financial information if the disposition is significant at the 20% level rather than the 10% level (to conform to the required significance threshold for acquisitions) and to otherwise conform the tests used to determine significance of a disposed business to those used to determine significance of an acquired business
- amending the pro forma financial information requirements to permit additional "management adjustments" to reflect reasonably likely effects of the transaction, in addition to the currently permitted and required adjustments

Although the SEC's requirements for financial disclosures under Regulation S-X will not apply to Canadian registrants using MJDS forms, there are many cases where MJDS forms cannot be used in certain types of M&A transactions, such as those in which a Canadian registrant is acquiring a U.S. domestic public company through a merger or a share exchange. As a result, the proposed changes, if adopted, could significantly benefit Canadian registrants undertaking those types of M&A transactions.

Opening the test-the-waters floodgates

Traditionally, securities laws in the United States made it difficult to test the waters before a public offering. Meetings with prospective investors to discuss their possible interest in a securities offering could be viewed as unlawful offers of the security, which were historically prohibited as "gun jumping" before a registration statement relating to the offering had been filed with the SEC.

Since 2012, the traditional rules have been changing. Under the *Jumpstart Our Business Startups Act* (the JOBS Act), the ability to test the waters with institutional investors first became available for an IPO or any subsequent public offering by an emerging growth company (EGC), as that term is defined by the JOBS Act, through the introduction of Section 5(d) under the U.S. *Securities Act*. In September, the SEC adopted a new rule to provide a second means of testing the waters with potential institutional investors that is available to all companies (Rule 163B), with an effective date of December 3, 2019.

Under new Rule 163B, any company and any person authorized to act on its behalf is permitted to engage in testing the waters communications. The result of the introduction of Rule 163B is that a broader range of issuers, not just EGCs, can more effectively consult with prospective institutional investors, better identify information that is important to prospective investors prior to embarking on a securities offering and, as a result, increase the likelihood of a successful offering.

Section 5(d) of the *Securities Act* remains available, in addition to Rule 163B, for any qualifying emerging growth company, and there may be advantages and disadvantages associated with using one rather than the other. Also, it is important to remember in the context of a cross-border securities offering that the Canadian test the waters rules work very differently from either Section 5(d) of the *Securities Act* or Rule 163B. Most notably, testing the waters in Canada can only be carried out by an issuer that has not yet completed an IPO, there

are fairly formalistic requirements for obtaining confidentiality undertakings from prospective investors and no testing the waters meetings can be held in the fifteen-day period preceding the IPO preliminary prospectus filing.

For more information, please refer to the Osler Update entitled *"Testing the waters" before a public offering of securities: Navigating the rules, without getting all wet* on osler.com.

Amendments to proxy rules relating to proxy advisors

In November, the SEC proposed amendments to its proxy rules designed to help investors using proxy voting advisory services to receive more accurate, transparent and complete information from proxy advisory firms. The proposed amendments would require proxy advisory firms to make disclosure of their actual or potential conflicts of interest and introduce new procedures to provide registrants with an opportunity to review and provide feedback on proxy advice before it is disseminated to investors.

In explaining the background to its proposed amendments, the SEC noted that proxy advisory firms provide voting advice to thousands of clients that exercise voting authority over a significant number of shares voted annually. It is therefore vital that proxy voting advice be based on the most accurate information possible and that proxy advisory firms be transparent with their clients about the processes and methods used to formulate their advice.

The proposed amendments are designed to help investors receive more accurate, transparent and complete information from the proxy advisory firms which provide voting advice to thousands of clients annually, making transparency vital.

Under the proposed amendments, proxy advisory firms would be required to prominently disclose in their advice

- any material interests, direct or indirect, of the proxy advisory firm (or its affiliates) in the matter or parties concerning which it is providing the advice
- any material transaction or relationship between the proxy advisory firm and the registrant, another soliciting person or a shareholder proponent, in connection with the matter
- any other information regarding the interest, transaction or relationship of the proxy advisory firm that is material to assessing the objectivity of the proxy voting advice in light of the circumstances of the particular relationship
- any policies and procedures used to identify, as well as the steps taken to address, any material conflicts of interest arising from such interest, transaction or relationship

The SEC also noted concerns that there could be factual errors, incompleteness or methodological weaknesses in the information and analyses of proxy voting firms that could materially affect the reliability of their voting recommendations and affect voting outcomes. The SEC stated that many registrants have also expressed concern that they lack an opportunity to review proxy voting advice before it is disseminated, as well as meaningful opportunities to engage with proxy advisory firms and to correct factual errors or methodological weaknesses in their analyses. Once voting advice is delivered to clients, which often occurs

very shortly before a significant percentage of votes are cast, it is not possible for registrants to inform investors on a timely basis of their contrary views or to point out errors they have identified in the analyses.

As a result, the SEC is proposing measures intended to facilitate improved dialogue between proxy advisory firms and registrants and other proxy soliciting persons before voting advice is disseminated to clients. The proposed measures are also designed to provide a means for registrants and other proxy soliciting persons to provide their views about the advice before proxy advisory firm clients vote.

Under the proposed amendments

- if a registrant subject to the SEC's proxy rules files its definitive proxy statement with the SEC less than 45 but at least 25 calendar days before the date of its shareholders meeting, proxy advisory firms would have to provide the registrant (or other proxy soliciting person) at least three business days to review the proxy advice and provide feedback
- if the registrant files its definitive proxy statement 45 calendar days or more before its shareholders meeting, the advance review period would increase to at least five business days
- if, however, the registrant files its definitive proxy statement less than 25 calendar days before the shareholders meeting, proxy advisory firms would have no obligation to share their advice in advance of its dissemination to their clients

Proxy advisory firms would also be required to provide registrants and other proxy soliciting persons with a final notice of their voting advice no later than two business days prior to the dissemination of advice to clients, regardless of whether or not the registrant or other proxy soliciting person provided feedback during the review and feedback period.

In addition to the review and feedback period and final notice requirements, registrants and other proxy soliciting persons would also have the option to request that proxy advisory firms include in their advice a hyperlink directing the recipient of the advice to a written statement that sets forth the registrant's or other proxy soliciting person's views on the advice.

The SEC's proxy rules do not apply to Canadian companies that qualify as a "foreign private issuer," which is the case for most Canadian companies that are SEC registrants. However, the SEC's proposed amendments would apply directly to any Canadian registrant that does not qualify as a foreign private issuer and may also be indirectly significant in influencing the practices of Canadian proxy advisory firms.

AUTHORS

Jason Comerford
Partner, Corporate
jcomerford@osler.com
212.991.2533

Rob Lando
Partner, Corporate
rlando@osler.com
212.991.2504

Jie Chai
Associate, Corporate
jchai@osler.com
212.991.2585

Kelsey Weiner
Associate, Corporate
kweiner@osler.com
212.991.2544