CLIENT UPDATE

# IMPORTANT LESSONS COME IN SMALL PACKAGES: SEC FOCUS ON MD&A TRENDS AND UNCERTAINTIES DISCLOSURE

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On August 21, 2014, Bank of America ("BOA") entered into a $16.65 billion settlement with the U.S. Department of Justice ("DOJ") to resolve federal and state claims over its sale of mortgage-backed securities. As part of the settlement with the DOJ, BOA entered into a $20 million settlement with the Securities and Exchange Commission ("SEC") in which BOA admitted that it failed to disclose to investors known uncertainties potentially adversely affecting its future income arising from its exposure to repurchase claims on securitized mortgage loans. The SEC's claim was predicated on a failure by BOA to include disclosure regarding known trends or uncertainties, as well as material changes to any such trends or uncertainties previously disclosed, in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of its periodic filings as required by Item 303 of Regulation S-K. Looking ahead to upcoming 10-Q and year-end 10-K periodic filings, we have summarized below the MD&A disclosure requirements and SEC guidance implicated by the BOA settlement and highlighted key practice takeaways.

## DISCUSSION AND ANALYSIS OF TRENDS AND UNCERTAINTIES

Item 303(a) of Regulation S-K requires the inclusion of an MD&A in annual reports on Form 10-K filed with the SEC for the purpose of providing "information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." SEC interpretive guidance dating back to 1989 states that one of the objectives of this rule is to allow the reader to evaluate if a company's past performance is indicative of its future performance. In this regard, Instruction 3 to Item 303(a) is critical. The instruction requires the MD&A to focus "on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition" and the SEC has made clear its view that companies should prepare the MD&A mindful of the fact that material forward-looking information regarding known material trends and uncertainties is required to be disclosed as part of the required discussion of those matters and the analysis of their effects.

Item 303(b) of Regulation S-K requires interim reports filed with the SEC on Form 10-Q to include analogous disclosure with a focus on "a discussion of material changes in those items specifically listed in Item 303(a)" other than the impact of inflation and changing prices on operations. In its settlement with BOA, the SEC emphasized that Item 303(b) requires "material changes to each and every specific disclosure requirement contained in paragraph (a), with the noted exception, [to] be discussed" and made clear that, as required by its 1989 guidance, disclosure of a known trend, demand, commitment, event or uncertainty is required unless management determines it is either (i) not reasonably likely to occur or (ii) if management is unable to make that determination, the event is not reasonably likely to have a material adverse effect on the company's financial condition or results of operations.

**REVIEW AND REINVIGORATE YOUR MD&A PROCESS**

We would recommend that, in the wake of the BOA settlement, senior management initiate a review of their company's disclosure controls and procedures underpinning the preparation of the MD&A and reinvigorate the process to ensure compliance with the applicable MD&A rules and SEC guidance. The process should ensure that known trends and uncertainties are identified by all business units and surfaced to senior management responsible for preparing and reviewing the MD&A. In particular, we suggest the following:

*Implement a Bottom-Up Process*

The management of each business unit is best positioned to be cognizant of the trends and uncertainties likely to affect its business. Accordingly, management of each business unit should be required to identify to the company's disclosure committee or senior management the trends, uncertainties or other factors that are likely to affect their business units. The disclosure committee or senior management can then determine whether those trends, uncertainties or factors are material to the company as a whole. During the MD&A preparation process, management of business units should also be required to sign off on disclosure relating to their units.

### *Obtain Senior Management Input*

The touchstone of quality MD&A is substantive input and review by senior management. Senior management is better situated to identify macro trends that will have an effect on the overall company or to see how trends affect multiple business units. Senior management is also better positioned to determine whether a trend or uncertainty affecting any particular business unit(s) is or is not material to the entire company. In performing its review of the MD&A, senior management should be guided to focus on events that have had or are reasonably expected to have a material (favorable or unfavorable) impact on the company's business and its financial condition and result of operations. The MD&A should adequately and clearly convey those factors, trends and uncertainties that senior management believes to be relevant to the company's business on a go-forward basis.

### *Employ a Clean Slate Approach*

Rather than simply marking up the preceding period's MD&A, the MD&A prepared for every periodic report should be drafted utilizing a clean slate approach. The draft disclosure should be tested against each Item 303 line-item disclosure requirement in order to maintain a focus, as appropriate, on material forward-looking information regarding known material trends and uncertainties relating to each line item disclosure.

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Please do not hesitate to contact us with any questions.

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