Bloomberg Law

Professional Perspective

New Rules for Omitting Competitively Sensitive Information in SEC-Filed Material Contracts

Richard Baltz, Arnold & Porter

New Rules for Omitting Competitively Sensitive Information in SEC-Filed Material Contracts

Contributed by Richard Baltz, Arnold & Porter

The Fixing America's Surface Transportation Act of 2015, 129 Stat. 1312, mandated that the U.S. Securities and Exchange Commission modernize and simplify certain of its disclosure requirements. On March 22, 2019, the SEC adopted amendments to several of its rules and regulations, including an alternative approach for the omission of confidential information in material contracts attached as exhibits to filings under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended.

The alternative procedures became effective on April 2, 2019. 84 Fed. Reg. 12,674. Following is a summary of these new procedures, addressing what can be redacted, how the new process will work, potential pitfalls, and the possibility of heightened scrutiny from the SEC under the new process.

What Can Be Redacted

New Alternate Procedures

Under the alternative procedures, registrants now may redact specified information in material contracts filed as exhibits to Security Act and Exchange Act reports without contemporaneously submitting a confidential treatment request as was previously required. The criteria supporting such redactions (now embedded within Item 601(b)(10) of Regulation S-K) remain the same. Information in a material contract may be redacted so long as that information is not material and would likely cause competitive harm to the registrant if publicly disclosed.

Earlier Rules (Still Available)

Prior to the effective date of the alternative CTR procedures, Securities Act Rule 406 and Exchange Act Rule 24b-2 set forth the exclusive mechanisms for requesting confidential treatment of information included in material contracts filed as exhibits to Securities Act and Exchange Act filings. Those rules, which still remain available for use, require companies to submit a detailed application to the SEC that identifies the particular text for which confidential treatment is being sought, a statement of the legal grounds under the Freedom of Information Act for the exemption, and an explanation of why, based on the facts and circumstances of the particular case, disclosure of the information would be both competitively harmful to the applicant and unnecessary for the protection of investors. A registrant also is required to specify an expiration date in its CTR.

In addition to the rules, SEC's Staff Legal Bulletin No. 1 (Feb. 28, 1997) and Staff Legal Bulletin 1A, with addendum (July 11, 2001), set forth its detailed views about the requirements a registrant must satisfy when submitting a CTR. In connection with an initial public offering, the staff reviews the CTR in conjunction with its review of the registration statement. All comments on the CTR must be resolved prior to requesting effectiveness. With respect to Exchange Act filings, the staff may decide not to review a CTR or to review the application and issue comments.

New Alternative Procedures

The most significant change under the alternative CTR procedures is that a registrant is no longer required to prepare and submit a CTR application when it files a material contract containing redactions. In the SEC's view, "the sizeable costs to registrants, in terms of financial expenditures, staff time, and potential transactional delays resulting because of time spent on confidential treatment request applications, justifies such an approach where, as here, any corresponding negative impact on investors is expected to be minimal." Release No. 33-10618, 84 Fed. Reg. 12,674, 12,681 (April 2, 2019) (Final Release).

To claim confidential treatment, registrants must:

- Mark the exhibit index to indicate that portions of the exhibit or exhibits have been omitted.
- Include a prominent statement on the first page of the redacted exhibit that certain identified information has been excluded from the exhibit because it is both not material and would be likely to cause competitive harm if publicly disclosed.
- Indicate with brackets where the information has been omitted from the filed version of the exhibit

In effect, this approach requires the registrant to assume responsibility (and liability) for determining whether all material information has been disclosed and whether the redacted information would be protected by one of the disclosure exemptions included in FOIA. Most commonly, that exemption would be the "(b)(4) exemption," which permits non-disclosure of certain trade secrets or privileged or confidential commercial or financial information. 5 U.S.C. §552(b)(4).

Potential Pitfalls

The new alternative CTR procedures do have some potential pitfalls.

Many agreements include strict confidentiality clauses with narrowly drawn exceptions. One such common exception allows a party to disclose terms of an agreement to comply with "applicable law" or, in some cases, the "rules and regulations of the SEC or another regulatory body." The right to disclose may be further qualified by a phrase like "in the reasonable opinion of the disclosing party's counsel."

If the contract is not processed under the tradition CTR regime, counsel to the contracting parties may be placed in the position of having to opine whether these types of exceptions are met. Materiality determinations involve difficult questions of fact and often end with informed, but subjective, judgments. Even if counsel can opine that an agreement must be filed to comply with an applicable law or regulation, he or she will not be able to assess the likelihood of competitive harm if the redacted information is publicly disclosed or address the appropriateness of the redactions.

Another common provision appearing in many agreements is a covenant requiring the registrant to provide a copy of the material agreement, as redacted, to the counterparty in advance of any filing. The counterparty then may review and comment on the scope of the redactions. Occasionally, a registrant's proposed approach to the disclosure is perceived by a counterparty as "too conservative" or "not protective" of what that counter-party views as commercially sensitive information.

Often overlooked by the counterparty in this type of situation is that, under either the traditional or alternative CTR regime, the disclosures are the responsibility of the registrant, and the redacted information must be competitively sensitive and immaterial to the registrant, not to the counterparty. Moreover, as stated in Section II.C.2 of Staff Legal Bulletin No. 1A, "[a]pplicants should note that an agreement between the parties to keep information confidential does not itself provide adequate justification for confidential treatment [and] [t]he [SEC's] confidential treatment system is premised on the disclosure requirements of the federal securities laws and FOIA, and does not contemplate non-disclosure based on a private contractual provision between the parties."

Possibility of Heightened Scrutiny

Although the alternative CTR procedures offer a welcome change to the traditional CTR regime, registrants may face heightened scrutiny when relying on those alternatives in addition to the issues like those described above. In dissenting from the SEC's adoption of the alternative CTR procedures, Commissioner Robert J. Jackson, Jr., stated, among other things, that the rules remove "our Staff's role as gatekeepers when companies redact information from disclosures—despite evidence that redactions already deprive investors of important information." Statement on Final Rules Implementing FAST Act (March 26, 2019).

Perhaps in response to Commissioner's Jackson's and others' concerns, the Final Release emphasizes that: "The amendments to Item 601 do not substantively alter registrant disclosure requirements—they do not affect the principles of what a registrant may or may not permissibly redact from its disclosure for reasons of confidentiality, nor do they change the fundamental disclosure obligations a registrant owes its shareholders under the federal securities laws." 84 Fed. Reg. at 12681.

Further, the SEC indicated in the final release that its staff will continue its review of filings and selectively assess whether redactions from exhibits appear to be limited to information that is not material and that would be likely to cause competitive harm if publicly disclosed.

To that end, on April 1, 2019, the day before the effective date of the alternative CTR procedures, the SEC formally announced that its staff would review filings for compliance with the alternative CTR procedures and issued additional guidance regarding the compliance review process. New Rules and Procedures for Exhibits Containing Immaterial, Competitively Harmful Information (April 1, 2019). The approach to that review turns, in part, on the type of filing made.

With respect to a general compliance review of a redacted exhibit, the staff will send a letter requesting that the registrant provide it with a paper copy of the unredacted exhibit marked to highlight the redacted information. The paper copy would be marked to show the redactions in the same manner as when a company submits a traditional CTR. Once the staff completes its review of the unredacted materials, it may or may not ask for further substantiation of the redaction decisions. The substantiation likely would include most of the same information that would appear in the application accompanying a traditional CTR. If that review does not lead to comments, the staff will send a letter indicating that the compliance review is complete.

With respect to an Exchange Act filing, the staff will make its initial request for an unredacted exhibit and the closing of review letter for that exhibit publicly available on EDGAR following the closing of its review. If that review was done in conjunction with a regular filing review, the staff will post the initial request and closing of review letter at the time it posts the other correspondence related to the filing review. Publicly available letters will only note the existence of an opened and a closed redacted exhibit compliance review.

In a significant departure from the traditional CTR procedures, if the staff requests a copy of an unredacted exhibit, a registrant may submit the agreement on a supplemental basis. As a result, a registrant may request confidential treatment of the exhibit and any accompanying materials under Rule 83 while the exhibit and materials are in the staff's possession. Following the completion of its review and at the request of the registrant, the staff either will destroy or return the exhibit and other materials, rather than retaining them in the SEC's files. A similar approach may be taken by registrants choosing to include exhibits with Item 1.01 Form 8-K filings.

Consistent with historical practice, the staff will require registrants to resolve any questions relating to redacted exhibits in registration statements filed under the Securities Act before submitting a request for acceleration of the registration statement's effective date. As a result, a registrant may still face the more rigorous review of redactions that it likely would encounter under the traditional CTR regime.

Considering this, a registrant may choose to use Securities Act Rule 406 despite the need to prepare a complete application for the CTR. Such an approach might streamline the review process because the application may answer some of the questions that the staff otherwise might pose later in the review process. Rule 406 also might prove useful when a counterparty to an agreement is insisting on aggressive redactions. In addition, although the staff will maintain the confidentiality of communications under the alternative CTR procedures, the formality and long history of the Rule 406 process may provide some additional level of comfort that competitively sensitive information will be protected.

Conclusion

When filing redacted exhibits under the streamlined CTR procedures, particularly in connection with exhibits to Exchange Act filings, a registrant should be mindful of the SEC's admonitions and Commissioner Jackson's dissent. While most compliance reviews likely will result only in comments and possibly amended filings, if the staff finds what it believes to be reckless or intentional non-compliance, the staff may refer the matter to the Enforcement Division for investigation and, if appropriate, enforcement action.

With these considerations in mind, each registrant should be prepared to demonstrate how it decides whether information in a material contract is both not material and would likely cause competitive harm if publicly disclosed. That decision-making process should be integrated into the registrant's system of disclosure controls and procedures. If the registrant maintains a disclosure or similar committee to oversee SEC filings, the committee's mandate could be extended to oversight of CTR determinations.

In addition, a registrant should consider preparing a memorandum or other contemporaneous documentation detailing its internal review process and addressing the bases for the redactions under the traditional CTR procedures. While such documentation would not have to be as comprehensive as a traditional CTR application, it might be useful in evidencing a registrant's awareness and consideration of the appropriate factors when making the redactions.

If the filing is selected for a compliance review, the registrant then could proactively provide its analysis to the staff upon receipt of the staff's request for an unredacted copy of an exhibit or use its analysis in framing a response to staff comments. At a minimum, documenting a process that demonstrates compliance with the alternative CTR procedures could mitigate against questions of bad intent or recklessness. This position could be further strengthened by involving outside counsel in the review, analysis, and preparation process.