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SEC Adopts Amendments to Required Financial Disclosures Regarding Acquisitions and Dispositions of Businesses

SEC Adopts Amendments to Update Significance Tests, Expand Use of Pro Forma Financial Information in Measuring Significance and Amend the Pro Forma Financial Information Requirements With Respect to Presenting Adjustments

SUMMARY

On May 21, 2020, the Securities and Exchange Commission issued a release adopting amendments to the financial disclosure requirements for financial statements of businesses acquired or to be acquired and for business dispositions.[1] The amendments also include new and amended rules for financial reporting of acquisitions by registered investment companies and business development companies. The amendments adopted by the release were initially proposed in May 2019 and will apply for fiscal years beginning after December 31, 2020.[2] Voluntary early adoption is permitted. Among other items, the amendments:

- modify the significance tests under the applicable rules by:
  - revising the investment test to compare the registrant's investment in and advances to the acquired or disposed business to the registrant's aggregate worldwide market value, if available;
  - revising the income test by adding a new revenue component;
  - expanding the use of pro forma financial information in measuring significance; and
  - conforming the significance threshold and tests for disposed businesses to those used for acquired businesses;
- codify the reporting practices for financial statements of acquired businesses that include significant oil- and gas-producing activities by requiring certain industry-specific disclosures on an unaudited basis for each full year of operations presented for the acquired business;

- modify and enhance the required disclosure for the aggregate effect of acquisitions for which financial statements are not required (or are not yet required);
- require the financial statements of the acquired business to cover no more than the two most recent fiscal years rather than up to the three most recent fiscal years;
- permit disclosure of financial statements that omit certain expenses for certain acquisitions of a component of an entity;
- permit in certain circumstances the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board;
- no longer require separate acquired business financial statements once the business has been included in the registrant's audited annual post-acquisition financial statements for nine months or a complete fiscal year, depending on the significance of the acquired business;
- amend the pro forma financial information requirements to include disclosure of:
  - "Transaction Accounting Adjustments," reflecting only the application of required accounting to the transaction;
  - "Autonomous Entity Adjustments," reflecting the operations and financial position of the registrant as an autonomous entity if the registrant was previously part of another entity; and
  - optional "Management Adjustments," depicting synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction;
- align Rule 3-14 relating to acquisitions of real estate operations with Rule 3-05 where no unique industry considerations exist and clarify the application of Rule 3-14 regarding, among other things, the determination of significance and the need for interim income statements;
- make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X, which will also apply to issuers relying on Regulation A;
- add a definition of significant subsidiary that is tailored for investment companies; and
- add a new rule and form to cover financial reporting of fund acquisitions by registered investment companies and business development companies.

Significant changes from the proposal include:

- ***Calculation of Income or Loss from Continuing Operations***. The SEC had proposed calculating income or loss from continuing operations after income taxes for purposes of determining significance under the income test. In response to comments received, the adopted amendments retain the existing requirement to use income or loss from continuing operations before income taxes;
- ***Omission of Pre-Acquisition Financial Statements for Certain Acquired Businesses***. In response to comments received, the SEC is allowing omission of pre-acquisition financial statements for businesses of 20% to 40% significance once they are included in the registrant's audited post-acquisition results for nine months, rather than for a complete fiscal year; and
- ***Elimination of Required Synergy Pro Forma Disclosures***. The SEC had proposed requiring registrants to disclose in the pro forma financial information Management Adjustments, which would reflect reasonably estimable synergies and transaction effects resulting from an acquisition. In response to comments received, the SEC made the disclosure of Management Adjustments optional and is requiring registrants to meet certain conditions before disclosing Management Adjustments.

I. GENERALLY APPLICABLE FINANCIAL STATEMENT REQUIREMENTS FOR ACQUIRED BUSINESSES

Rule 3-05 of Regulation S-X generally requires the inclusion of financial statements of an acquired business when the acquired business is significant to the registrant. Whether an acquisition is significant under Rule 3-05 is determined by applying the investment, asset and income tests provided in the "significant subsidiary" definition in Rule 1-02(w). Rule 3-05 requires the registrant to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business ("Rule 3-05 Financial Statements") if any of the investment, asset or income tests exceeds the 20% significance threshold. The periods for which Rule 3-05 Financial Statements are required also depend on the relative significance of the business acquired or to be acquired.[3]

A. SIGNIFICANCE TESTS

The SEC updated the significance tests by adopting amendments to the investment and income tests, which the release notes are intended to more accurately reflect the relative significance of the acquired business to the registrant and to reduce the likelihood of anomalous results in the application of the current "significant subsidiary" definition.[4,5] The amendments also conform, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine significance of an acquired business.

1. Investment Test

Under the current rules, the investment test compares the investment in and advances to the acquired business to the registrant's total assets as reflected in the registrant's most recent annual financial statements required to be filed at or prior to the date of acquisition. The amendments revise the investment test to instead compare the registrant's investment in and advances to the acquired business to the aggregate worldwide market value of the registrant's voting and non-voting common equity ("aggregate worldwide market value"). The "aggregate worldwide market value" will be determined using the average of aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition (which was a significant departure from the original proposal to calculate the value based on the end of the last preceding fiscal year). The new prong is expressly limited to acquisitions and dispositions where an aggregate worldwide market value of the registrant is available; thus, the definition applicable to determining significance of a wholly owned subsidiary would not change in practice. The comparison to the registrant's total assets used in the existing investment test is retained for testing significance of equity method investees under Rule 3-09 and Rule 4-08(g) of Regulation S-X.

2. Income Test

The income test currently compares a registrant's equity in the income from continuing operations of the acquired business before income taxes (exclusive of amounts attributable to any noncontrolling interests, as reflected in the acquired business's most recent annual pre-acquisition financial statements) to the same measure of the registrant reflected in the registrant's most recent annual financial statements required to be filed at or prior to the acquisition. The amendments revise the income test to add a new revenue component that compares the total revenue from continuing operations (after intercompany eliminations) of the acquired business to the total revenue (after intercompany eliminations) of the registrant in its most recent fiscal year.

The new revenue component will be applicable if both the registrant (including its consolidated subsidiaries) and the tested subsidiary have material revenue in each of the two most recently completed fiscal years. If this condition is satisfied, Rule 3-05 Financial Statements will be required only if the new revenue component *and* the net income component both meet the 20% significance threshold.[6] Similar to the principle set forth for the investment test revisions, if either the registrant or the tested subsidiary did not have material revenue as required, only the net income test will apply.

Contrary to the SEC's proposed amendments released in May 2019, which calculated income or loss from continuing operations *after* income taxes, the final amendments retained the requirement under the current rules to use income or loss from continuing operations *before* income taxes. According to the release, the current formula is being maintained in order to avoid distortion due to factors such as the tax status of the entity or the volatility of income taxes.

B. GENERAL RULES RELATING TO REQUIRED PERIODS FOR RULE 3-05 FINANCIAL STATEMENTS

Under the current rules, except where securities are being registered to be offered to the security holders of the business to be acquired, Rule 3-05 Financial Statements must be provided for the number of periods as set forth in Table 1 below. Financial statements for interim periods may be unaudited but must be prepared in comparative form to include the comparative period for the prior fiscal year. Once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year, Rule 3-05 Financial Statements are no longer required unless the financial statements have not been previously filed or the acquisition is deemed to be of major significance.[7]

The amendments eliminate the requirement set forth above to provide three years of Rule 3-05 Financial Statements where the relative significance of the acquired or to be acquired business exceeds 50%. The SEC notes that, in accordance with Rule 4-01(a) of Regulation S-X, registrants will still be required to provide information (including, presumably, a third year of Rule 3-05 Financial Statements) if the Rule 3-05 Financial Statements otherwise presented would be misleading.

The amendments further revise the requirement to provide Rule 3-05 Financial Statements for "any required interim period" under the 20% to 40% relative significance band with a requirement to provide Rule 3-05 Financial Statements for the "most recent" interim period. This change effectively eliminates the requirement for the registrant to present a comparative interim period of Rule 3-05 Financial Statements, as the SEC notes that such comparative financials might be of limited utility to investors, and their preparation may place additional burdens on registrants.

Set forth in the tables below is a comparison of the required periods for Rule 3-05 Financial Statements under the current rules and under the amendments:

Table 1: Required Periods for Rule 3-05 Financial Statements under Existing Rules

Relative Significance of Acquired or To Be Acquired Business ("x")	Number of Periods Required Under Existing Rules
20% < x ≤ 40%	Most recent fiscal year (audited) and any interim periods (unaudited)
40% < x ≤ 50%	Two most recent fiscal years (audited) and any interim periods (unaudited)
x > 50%	Three most recent fiscal years (audited) and any interim periods (unaudited)[8]

Table 2: Required Periods for Rule 3-05 Financial Statements under Amended Rules

Relative Significance of Acquired or To Be Acquired Business ("x")	Number of Periods Required Under Amended Rules
20% < x ≤ 40%	Most recent fiscal year (audited) and most recent interim period only (unaudited)
x > 40%	Two most recent fiscal years (audited) and any interim periods (unaudited)

The amendments do not substantively modify the financial statement requirements set forth in Rule 3-05(b)(1), which apply where securities are being registered to be offered to the security holders of the business to be acquired.

C. FINANCIAL STATEMENTS FOR NET ASSETS THAT CONSTITUTE A BUSINESS

Under certain circumstances—such as when registrants acquire a product or business line that is a "business" for reporting purposes but does not constitute a separate entity, subsidiary or division—the amendments allow registrants to provide audited financial statements for the acquired "businesses" that exclude corporate overhead, interest and income tax expense. These changes are meant to address situations where preparing Rule 3-05 Financial Statements including these specific expenses would be impractical.[9]

Specifically, a registrant could provide such abbreviated financial statements under the amendments if the following conditions were met:

- the total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20% or less of such corresponding amounts of the seller and its consolidated subsidiaries as of and for the most recently completed fiscal year;
- the acquired business was not a separate entity, subsidiary, operating segment or division during the periods for which the acquired business financial statements would be required;
- separate financial statements for the business have not previously been prepared; and
- the seller has not maintained the distinct and separate accounts necessary to present financial statements that include the omitted expenses and it is impracticable to prepare such financial statements.

If the acquired or to be acquired business satisfies the above conditions, the release provides certain clarifications on the presentation of the audited abbreviated financial statements, including:

- the balance sheet may be a statement of assets acquired and liabilities assumed;
- the statement of comprehensive income may be a statement of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) if certain presentation requirements are met, and the title of the statement of comprehensive income must be appropriately modified to indicate it omits certain expenses;
- the statement of comprehensive income must include expenses incurred by or on behalf of the acquired, including, but not limited to, costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development, but may otherwise omit corporate overhead expenses;
- interest expense may be excluded from the statements if the debt to which the interest expense relates will not be assumed by the registrant or its consolidated subsidiaries;
- income tax expense may be omitted; and
- the notes to the financial statements must include certain additional disclosures specified in the amendments.

D. CLARIFICATIONS TO THE TIMING AND TERMINOLOGY OF FINANCIAL STATEMENT REQUIREMENTS

The amendments include a number of changes to Rule 3-05 and Article 11, which are clarifying in nature and are meant to codify practices that have developed since the adoption of these rules. Among other items, these amendments:

- specify that financial statements are required if a business acquisition has occurred during the most recent fiscal year or subsequent interim period for which a balance sheet is required under Rule 3-01, or if a business acquisition has occurred or is probable after the date that the most recent balance sheet has been filed by the registrant;
- clarify that Rule 3-05 applies when the fair value method is used in lieu of the equity method to account for an acquisition;
- clarify that information provided under Rule 3-05 and Article 11 is “filed” and not “furnished”; and
- provide explicitly that registrants may continue to determine significance using amounts reported in the registrant’s Form 10-K for the most recent fiscal year when the Form 10-K has been filed after the acquisition consummation date, but before the registrant is required to file financial statements of the business on Form 8-K.

E. FOREIGN BUSINESSES

To alleviate burdens on certain foreign businesses or registrants acquiring such foreign businesses, the amendments also expand the use of or reconciliation to International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). Specifically, the amendments permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile Rule 3-05 financial statements of foreign businesses prepared using home country GAAP to IFRS-IASB rather than U.S. GAAP. In addition, the amendments permit Rule 3-05 financial statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would qualify as a foreign private issuer if it were a registrant.[10] The amendments further permit an acquired business that would qualify as a foreign private issuer if it were a registrant to reconcile to IFRS-IASB rather than U.S. GAAP when the registrant is a foreign private issuer that uses IFRS-IASB.

II. RULE 3-05 FINANCIAL STATEMENTS INCLUDED IN REGISTRATION STATEMENTS AND PROXY STATEMENTS

A. EXPANSION OF REGISTRANT'S ABILITY TO OMIT RULE 3-05 FINANCIAL STATEMENTS FOR BUSINESSES THAT HAVE BEEN INCLUDED IN THE REGISTRANT'S FINANCIAL STATEMENTS

Rule 3-05 currently has specific provisions relating to the financial statements required in registration statements and proxy statements. One provision of the current rules generally permits a registrant to omit Rule 3-05 Financial Statements in registration statements and proxy statements if the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year. However, this omission of the Rule 3-05 Financial Statements is not permitted if either (i) the Rule 3-05 Financial Statements have not been previously filed, or (ii) the Rule 3-05 Financial Statements have been previously filed, but the acquired business is of "major significance" to the registrant. An acquired business is deemed to be of "major significance" if omission of the Rule 3-05 Financial Statements would materially impair an investor's ability to understand the historical financial results of the registrant. Rule 3-05 provides, as an example of "major significance," an acquired business that exceeds at the 80% level the significance threshold under any Rule 1-02(w) significant subsidiary test.

The amendments eliminate each of these exceptions. However, registrants continue to be subject to the general obligation to provide "such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading" under Regulation S-X.[11] Further, the amendments revise the length of reporting periods required under Rule 3-05 to provide consistency with Rule 3-06. Specifically, the amendments allow omission of pre-acquisition financial statements for businesses that exceed 20% significance but do not exceed 40% significance once they are included in the registrant's audited post-acquisition results for nine months. For businesses that exceed 40% significance, pre-acquisition financial statements may be omitted once the operating results of the

acquired business are included in the registrant's post-acquisition results for a complete fiscal year. The SEC believes that inclusion of the post-acquisition results in the registrant's financial statements for the requisite time period at these significance thresholds should provide investors with sufficient information to make informed investment decisions.

B. USE OF PRO FORMA FINANCIAL STATEMENTS TO MEASURE SIGNIFICANCE

The current rules permit registrants to calculate the relative significance of the acquired business based on pro forma financial information, rather than on a historical basis, if the registrant has made a significant acquisition subsequent to the latest fiscal year-end and the registrant has filed Rule 3-05 Financial Statements and pro forma financial information on Form 8-K for that acquisition. Currently, registrants filing initial registration statements or those with significant dispositions cannot similarly calculate significance using such pro forma financial information. The amendments expand the use of pro forma financial information for significance tests to all filings that may require Rule 3-05 Financial Statements or Rule 3-14 Financial Statements (discussed in Section IV.A below) if (i) the registrant has filed Rule 3-05 Financial Statements or Rule 3-14 Financial Statements for the acquired business and (ii) the registrant has filed the pro forma financial information required by Article 11 for any such acquisition or disposition. Once a registrant uses pro forma financial information to measure significance, it must continue to use pro forma financial information to measure significance until its next annual report on Form 10-K or Form 20-F.

C. REVISED DISCLOSURE REQUIREMENTS FOR INDIVIDUALLY INSIGNIFICANT ACQUISITIONS

Currently, registrants are required to provide audited historical pre-acquisition financial statements covering a substantial majority of individually insignificant acquired businesses in a registration statement or proxy statement if the aggregate impact of the individually insignificant businesses exceeds the 50% significance level. The current rules also require registrants to provide related pro forma financial information under Article 11 in such circumstances.

The amendments continue to require disclosure if the aggregate impact of businesses acquired or to be acquired exceeds the 50% significance level. The amendments clarify that "individually insignificant businesses" include: (a) any acquisition consummated after the registrant's audited balance sheet date whose significance does not exceed 20%; (b) any probable acquisition whose significance does not exceed 50%; and (c) any consummated acquisition whose significance exceeds 20%, but does not exceed 50%, for which financial statements are not yet required because of the 75-day filing period.[12]

Under the amendments, the pre-acquisition historical financial statements will only be required for those businesses whose individual significance exceeds 20%. In conjunction with this change, the amendments require registrants to provide pro forma financial information depicting the aggregate effects of all "individually insignificant businesses" in all material respects. The amendments clarify that pro forma financial information will need to be provided even if separate financial statements of the acquired business are not included in the filing when the aggregate impact is significant as determined by amendments. The

amendments also require registrants to include both Rule 3-05 businesses and Rule 3-14 real estate operations when determining the aggregate impact of the investment test for individually insignificant acquisitions.

III. PRO FORMA FINANCIAL STATEMENTS UNDER ARTICLE 11

Rule 3-05 Financial Statements and Rule 3-14 Financial Statements must normally be accompanied by Article 11 pro forma financial information that reflects the impact of the acquired business or acquired real estate operations. Pro forma financial statements are also required in connection with significant dispositions and other specified situations. The pro forma financial information typically includes the most recent balance sheet and most recent annual and interim period income statements.

A. ADJUSTMENT CRITERIA AND PRESENTATION REQUIREMENTS

Article 11 currently provides flexibility for registrants to make adjustments and to tailor the presentation of pro forma financial information with a goal of eliciting disclosures that distinguish between the one-time impact and the ongoing impact of an acquisition transaction. These adjustments are only permitted if certain criteria are satisfied and the release notes that the existing application criteria are not clearly defined and, in practice, result in pro forma financial adjustments that are inconsistent even for similar fact patterns.[13]

To address these concerns, the amendments eliminate the existing adjustment criteria and instead permit adjustments in three principal categories: "Transaction Accounting Adjustments," "Autonomous Entity Adjustments" and "Management Adjustments." Transaction Accounting Adjustments will reflect only the application of required accounting for the acquisition transaction under U.S. GAAP or IFRS-IASB. Autonomous Entity Adjustments will reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity. Management Adjustments will provide flexibility for the registrant to include forward-looking information depicting the synergies and other potential effects of the acquisition and the post-acquisition plans expected to be taken by management in the pro forma financial information. Under the final amendments, Transaction Accounting Adjustments and Autonomous Entity Adjustments are required adjustments, whereas Management Adjustments are optional. Autonomous Entity Adjustments must be presented in a separate column from Transaction Accounting Adjustments.

Under the amendments, Management Adjustments may, in the registrant's discretion, be presented if in its management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction. In addition, the registrant must meet the following conditions to present Management Adjustments:

- there is a reasonable basis for such adjustments;

- the adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented; and
- the pro forma financial information reflects all Management Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed. When synergies are presented, any related dis-synergies must also be presented.

The amendments also explicitly require the registrant, if presenting Management Adjustments, to: (i) present Management Adjustments in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest, and the related pro forma earnings per share data, to such amounts after giving effect to Management Adjustments; (ii) when including Management Adjustments in or incorporating Management Adjustments by reference into a registration statement, proxy statement, offering statement or Form 8-K, update the Management Adjustments so that they are of the most recent practicable date prior to the relevant date (e.g., effective date, mail date, qualified date or filing date, as applicable); and (iii) include in the explanatory notes the basis for and material limitations of each Management Adjustment, including the estimated time frame for achieving the synergies and dis-synergies of such adjustment.

The amendments include a number of additional clarifying changes, which, among other items, explicitly require the registrant to provide: (i) accompanying explanatory notes to the pro forma financial information; and (ii) separate columnar information for each transaction for which pro forma effects are required to be presented. Lastly, the amendments include an instruction indicating that any forward-looking information supplied is expressly covered by the safe harbor provisions under Rule 175 under the Securities Act and Rule 3b-6 under the Securities Exchange Act of 1934.

Under current practice, acquiring companies that do not require a shareholder vote on the transaction would generally not provide their views on synergies in a Form S-4 registration statement unless they were otherwise shared with the target or were otherwise made public. Commenters identified many significant issues potentially raised by the proposed rules' requirement to reflect Management Adjustments in pro forma financial statements. To address these concerns, under the amendments Management Adjustments are permitted, rather than required, but acquirors are encouraged to reflect them in pro forma information included in a Form S-4 registration statement. It will be interesting to see how practice evolves in this area, but given the likely amount of time involved in preparation of the Management Adjustments and the need for at least one update of these adjustments, as well as potential liability concerns, some registrants may elect not to include these adjustments.

B. SIGNIFICANCE THRESHOLD FOR DISPOSED BUSINESSES

Rule 11-01 currently requires a registrant to provide certain pro forma financial information for significant dispositions and probable dispositions that are not otherwise reflected in the registrant's financial

statements. This information is currently required if the disposition meets the 10% significance test under Rule 1-02(w). To conform this test to the significance threshold applicable under Rule 3-05, the amendments revise the significance threshold under Rule 11-01 to 20%. Further, the amendments conform the significance tests for disposed businesses to the changes adopted for the significance tests of acquired businesses, as discussed further in Section I.A above.

IV. FINANCIAL STATEMENTS OF REAL ESTATE OPERATIONS ACQUIRED OR TO BE ACQUIRED UNDER RULE 3-14

A. ALIGNMENT OF RULE 3-14 TO ADOPTED CHANGES TO RULE 3-05

Rule 3-14 generally requires registrants to file abbreviated financial statements with respect to significant acquisitions of "real estate operations" ("Rule 3-14 Financial Statements"). Rule 3-14 Financial Statements are abbreviated (in comparison to Rule 3-05 Financial Statements) in order to exclude certain historical items that are not comparable to the proposed future operations of the real estate operation, such as mortgage interest, leasehold rental, depreciation, corporate expenses and income taxes. Additionally, Rule 3-14 generally requires registrants to file only one year of Rule 3-14 Financial Statements, in comparison to Rule 3-05's requirement to potentially require up to three years of Rule 3-05 Financial Statements.

The SEC has adopted a number of amendments to Rule 3-14 in order to conform the rule with Rule 3-05 where no unique industry conditions warrant differential treatment. Among other conforming changes, the amendments:

- apply an explicit 20% significance threshold to Rule 3-14 for individual acquisitions and an explicit 50% significance threshold to Rule 3-14 for the aggregate impact of acquisitions;
- eliminate the requirement to include additional periods in connection with related party transactions;
- align the period for Rule 3-14 Financial Statements to the requirements under Rule 3-05; and
- no longer require Rule 3-14 Financial Statements in registration statements and proxy statements once the acquired real estate operation is reflected in filed post-acquisition registrant financial statements for nine months.

B. OTHER SIGNIFICANT CHANGES TO RULE 3-14

Rule 3-14 currently does not include an explicit definition of "real estate operations" that would need to be tested for significance. To clarify the rule, the SEC is amending Rule 3-14 to define real estate operations as "a business that generates substantially all of its revenues through the leasing of real property." This definition is meant to be clarifying in nature and is generally consistent with the SEC's previous interpretation of this term for purposes of Rule 3-14.

The amendments also include revisions to Rule 3-14 that require Rule 3-14 Financial Statements for the most recent year-to-date interim period prior to the acquisition[14] and clarify that significance should be based only on the investment test. The investment test for determining the significance of real estate operations compares the registrant's investment in the real estate operations, including any debt secured by the real properties that are assumed by the registrant, to the registrant's total assets at the last audited fiscal year-end.[15] Unlike for acquisitions of real estate operations, however, the SEC is not adopting for dispositions of real estate operations the revisions to the investment test that would include debt secured by the real properties assumed by the buyer when the registrant's investments in and advances to the real estate operations are being compared to total assets of the registrant.

V. FINANCIAL DISCLOSURE ABOUT ACQUISITIONS SPECIFIC TO INVESTMENT COMPANIES

Investment company registrants and business development companies (collectively, "investment companies") are generally subject to the general provisions of Article 3 of Regulation S-X, unless special provisions set forth in Article 6 of Regulation S-X apply. Article 6 does not contain specific rules or requirements for investment companies relating to the financial statements of acquired funds. Therefore, investment companies currently comply with the financial reporting requirements that apply generally with respect to acquisitions of investment companies and other types of funds (collectively, "acquired funds"). The SEC is adopting amendments to Regulation S-X that are designed to tailor the financial reporting requirements of registered investment companies with respect to the acquisition of investment companies and other types of funds. The SEC is also adopting related changes to Form N-14 to conform the form's disclosure requirements to the newly adopted rules discussed below.

A. SIGNIFICANCE TESTS

Investment companies are currently required to use the significant subsidiary tests in Rule 1-02(w) when applying Rule 3-05 and other rules of Regulation S-X, which, as discussed above, includes the investment, asset and income tests. Rule 8b-2 under the Investment Company Act has two different tests for the definition of a significant subsidiary, which does not apply to Securities Act filings. The SEC is adopting new Rule 1-02(w)(2) to create a separate definition of "significant subsidiary" that is tailored for investment companies and is also adopting related amendments to Rule 8b-2 to conform it to new Rule 1-02(w)(2). In summary, the new rules reflect an income test and an investment test that resemble, but modify, the existing tests set forth in Rule 8b-2. The amendments eliminate the asset test with respect to investment companies, because, among other reasons, the asset test as applied to investment companies frequently duplicates the investment test.

1. Investment Test

The new investment test for investment companies determines significance by evaluating whether the value of the registrant's and its other subsidiaries' investment in and advances to the tested subsidiary exceeds 10% of the value of the total investments of the registrant and its consolidated subsidiaries as of the end of the most recently completed fiscal year. The value of the registrant's total investments will be determined in accordance with U.S. GAAP and, in the case of investment company registrants, Section 2(a)(41) of the Investment Company Act. The new test is similar to the current investment test under Rule 8b-2, except that it uses the value of total investments rather than total assets. The SEC believes that modifying the investment test in this way more appropriately focuses the significance determination on the impact of the registrant's investment portfolio as opposed to other non-investment assets that may be held.

2. Income Test

The current income test under Rule 8b-2 compares the total investment income of the subsidiary or net income (in the case of a non-investment company subsidiary) to the total investment income of the parent or, if consolidated statements are filed, the total investment income of the parent and its consolidated subsidiaries. Under the amendments, the new income test applicable to investment companies modifies the numerator of this test to include: (i) investment income from dividends, interest and other income; (ii) the net realized gains and losses on investments; and (iii) the net change in unrealized gains and losses. The tested subsidiary will be considered significant if the absolute value of the sum of these three items exceeds (A) 80% of the absolute value of the change in net assets resulting from operations of the investment company and its consolidated subsidiaries for the most recently completed fiscal year; or (B) 10% of the absolute value of the change in net assets resulting from operations of the investment company and its consolidated subsidiaries for the most recently completed fiscal year and the Investment Test condition exceeds 5%.[16] If the absolute value of the change in net assets resulting from operations of the registrant and its consolidated subsidiaries is at least 10% lower than the average of the absolute value of such amounts for each of its last five fiscal years, the amendments permit the investment company to calculate both condition (A) and condition (B) of the test using the average of the absolute value of such amounts for the registrant and its consolidated subsidiaries for each of its last five fiscal years.

B. NEW RULE 6-11 OF REGULATION S-X

The release adopts new Rule 6-11 of Regulation S-X, which modifies the existing requirements applicable to financial reporting for acquired funds[17] under Rule 3-05 and Rule 3-14 in a manner that is tailored to investment companies and their investors. Among other items, new Rule 6-11 requires:

- only one filing of financial statements of the acquired fund for the most recent fiscal year and the most recent interim period (as opposed to the existing requirement to provide up to three years of Rule 3-05 Financial Statements); and
- filing of Article 12 schedules for the acquired fund.[18]

In addition, the financial statements of private funds may comply with either U.S. GAAP or Article 12. Consistent with the approach under Rule 3-05 applicable to non-investment companies, Rule 6-11 replaces each reference to the significance threshold of 10% under new Rule 1-02(w)(2) with a 20% threshold.[19] Financial statements of the acquired fund are required if either of the investment or income tests[20] is satisfied at the 20% level, unless the audited balance sheet required by Rule 3-01 or Rule 3-18 is filed for a date after the date the acquisition was consummated. Similar to Rule 3-05, Rule 6-11 requires filing of financial statements for each fund that is otherwise individually insignificant if the aggregate impact of the individually insignificant funds meets the conditions of the investment test and the alternate income test for investment companies is satisfied at the 50% significance threshold. The amendments also permit the use of pro forma financial information in significance calculations to give effect to recent acquisitions under certain circumstances, consistent with the changes to Rule 3-05 discussed above.

C. SUPPLEMENTAL INFORMATION IN LIEU OF PRO FORMA FINANCIAL INFORMATION FOR ACQUISITIONS BY INVESTMENT COMPANY REGISTRANTS

Noting the potential limited use to investors of pro forma financial information in the context of investment company registrants in connection with fund acquisitions, the amendments eliminate the current requirements for investment company registrants to provide pro forma financial information and instead require certain supplemental disclosures. The supplemental information includes: (i) a pro forma fee table, setting forth the post-transaction fee structure of the combined entity; (ii) if the transaction will result in a material change in the acquired fund's investment portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to show the effects of such change and accompanied by narrative disclosure describing the change; and (iii) narrative disclosure about material differences in accounting policies of the acquired fund when compared to the acquiring fund.

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ENDNOTES

1 Securities Exchange Act Release No. 33-10786; 34-88914; IC-33872; File No. S7-05-19 (May 21, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10786.pdf.

2 For further information about the proposing release, please see our Memorandum to Clients, "Financial Disclosure About Acquired and Disposed Businesses" (May 8, 2019), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Financial-Disclosures-About-Acquired-and-Disposed-Businesses.pdf.

3 See Section I.B for adopted amendments regarding the number of periods for which Rule 3-05 Financial Statements need be presented.

4 The SEC is also revising the significance tests applicable in the context of investment companies, as described further in Section V.A.

5 To preserve consistency, the changes to Rule 1-02(w) also revise the significance tests under other rules that rely on the Rule 1-02(w) "significant subsidiary" test.

6 To determine the number of periods for which Rule 3-05 Financial Statements are required, the amendments require the registrant to use the lower of the significance calculation from the revenue component and the net income component.

7 See Section II.A for adopted revisions to this component of Rule 3-05.

8 In 2018, in connection with the adoption of a revised definition of smaller reporting company, the SEC permitted the exclusion of the earliest of the three fiscal years if net revenues reported by the acquired business in its most recent fiscal year were less than $100 million.

9 Historically, the SEC has permitted businesses that generate substantially all of their revenues from oil- and gas-producing activities to omit additional expenses from the Rule 3-05 Financial Statements, including historical depreciation, depletion and amortization expenses, if the registrant provides additional industry specific disclosures as specified in FASB ASB Topic 932. The SEC has also adopted a new Rule 3-05(f) to codify these reporting practices when certain conditions are satisfied.

10 These changes are meant to address scenarios under the current rules where an acquired business qualifies as a "foreign private issuer," but not as a "foreign business" because of different ownership requirements for each of those definitions. This divergence currently results in the registrant providing Rule 3-05 Financial Statements for the acquired business that are prepared in accordance with U.S. GAAP, even though such financial statements are not already available and result in significant preparation cost.

11 See Rule 4-01(a).

12 See Rule 3-05(b)(4), which provides a 75-day grace period for the filing of acquired business financial information required under Rule 3-05, subject to certain conditions.

13 The existing criteria generally permit adjustments to the balance sheet data, regardless of whether the particular transaction impact is continuing or non-recurring. In contrast, adjustments to the statements of comprehensive income may only be made if the adjustments are (i) directly attributable to the transaction, (ii) expected to have a continuing impact on the registrant, and (iii) factually supportable.

14 Currently, unlike Rule 3-05, Rule 3-14 does not include an express requirement for registrants to provide interim financial information.

15 This codification is consistent with prior staff interpretations, which have encouraged registrants to focus on this version of the investment test when determining significance under Rule 3-14.

ENDNOTES (CONTINUED)

[16] While the significant subsidiary test applicable to investment companies under Rule 1-02(w)(2) will include this 10% significance threshold, this threshold will be replaced with a 20% significance threshold for purposes of evaluating the significance of acquired funds under new Rule 6-11, to conform to the 20% significance test on comparable conditions in current Rule 3-05.

[17] For purposes of Rule 6-11, "fund" includes any investment company as defined in Section 3(a) of the Investment Company Act, including a business development company, or any company that would otherwise be an investment company but for the exclusions provided in section 3(c)(1) or section 3(c)(7) of the Investment Company Act, or any private account managed by an investment advisor. In the case of an acquisition of a private account, only the Article 12 schedules are required.

[18] Article 12 schedules for the acquired fund require each investment of the fund to be listed separately. While the amended rule permits registrants to file financial statements for private funds that were prepared in accordance with U.S. GAAP (which do not require this level of granular information), the Article 12 schedules will need to accompany the U.S. GAAP financial information for investors to obtain all material information.

[19] See Section V.A for a discussion of new Rule 1-02(w)(2).

[20] Under Rule 6-11, the income determination with respect to the income test for an acquired fund is made by comparing the absolute value of the change in net assets resulting from operations of the tested subsidiary with that of the investment company registrant.

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