

May 8, 2019

Financial Disclosures About Acquired and Disposed Businesses

Proposed Amendments 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 3, 2019, the Securities and Exchange Commission issued a release proposing amendments to the financial disclosure requirements for financial statements of businesses acquired or to be acquired and for business dispositions. The Commission also proposed new and amended rules for financial reporting of acquisitions by registered investment companies and business development companies. Among other items, the proposed changes would:

- update the significance tests under the applicable rules by revising the investment test to compare the registrant's investment in and advances to the acquired business to the aggregate worldwide market value and the income test to add a new revenue component and to revise the calculation of net income by using income or loss from continuing operations after taxes, rather than before;
- expand the use of pro forma financial information in measuring significance;
- conform the significance threshold and tests applicable to a disposed business;
- limit the required financial statements of the acquired business to the two most recent fiscal years rather than up to the three most recent fiscal years;
- permit the use of abbreviated financial statements in connection with certain acquisitions of a component of an entity;
- permit in certain circumstances the use of International Financial Reporting Standards as issued by the International Accounting Standards Board;
- require separate acquired business financial statements only until the business has been included in the registrant's post-acquisition financial statements for a complete fiscal year;

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- amend the pro forma financial information requirements to include disclosure of “Transaction Accounting Adjustments,” reflecting the accounting for the transaction, and “Management’s Adjustments,” reflecting reasonably estimable synergies and transaction effects;
- 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 the determination of significance and the need for interim income statements;
- add a definition of significant subsidiary that is tailored for investment companies; and
- add new provisions to cover financial reporting of fund acquisitions by registered investment companies and business development companies.

Comments are due by the date that is 60 days after publication of the release in the Federal Register.

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 depends on the relative significance of the business acquired or to be acquired.¹

A. SIGNIFICANCE TESTS

The first part of the release includes the SEC’s proposed 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 anomalous results in the application of the current “significant subsidiary” definition.^{2,3}

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 its most recent annual financial statements required to be filed at or prior to the date of acquisition. The proposed amendments would 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”). For purposes of the proposed rule, the “aggregate worldwide market value” would be determined as of the last business day of the registrant’s most recently completed fiscal year and the value of common equity held by affiliates would be included. In cases where the registrant does not have an aggregate worldwide market value, the existing test would be retained. As a

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result, the definition applicable to determining significance of a wholly-owned subsidiary would not change in practice, and the new prong would apply only to acquired businesses and would compare the acquisition price to the aggregate worldwide market value of the acquiring company at the end of the most recently completed fiscal year.

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 controlling interests, as reflected in the acquired business's most recent annual pre-acquisition financial statements) to the same measure of the registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition. The proposed amendments would revise the income test to add a new revenue component and would revise the calculation of net income by using income or loss from continuing operations after taxes, rather than before.

The new revenue component, which would compare the total revenue from the acquired business to the total revenue of the registrant in its most recent fiscal year, would be applicable if both the registrant and its subsidiaries consolidated and the subsidiary being tested have recurring annual revenue. If this condition is satisfied, Rule 3-05 Financial Statements would be required only if the new revenue component and the net income component both meet the 20% significance threshold.⁴ Similar to the principle set forth for the investment test revisions, if both the registrant or the tested subsidiary do not have recurring annual revenues, only the net income test would apply.

The proposal would also revise the net income component so that it is calculated based on income or loss from continuing operations *after* income taxes. The SEC notes that income tax is a recurring and material line item and that the current approach of excluding income tax from the calculation may require registrants to perform additional calculations to remove the tax impact from figures reported in the registrant's financial statements reported on an after-tax basis.

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 the table 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.⁵

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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) ⁶

The proposed rules would 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 would be 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 proposed rules would 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 would effectively eliminate 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 otherwise place additional burdens on registrants.

Consequently, the proposed rules would result in the following financial statement requirements:

Relative Significance of Acquired or To Be Acquired Business (“x”)	Number of Periods Required Under Proposed 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 proposed rules do not seek to amend the financial statement requirements set forth in Rule 3-05(b), 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 proposal would 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.⁷

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

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- the acquired business constitutes less than substantially all of the assets and liabilities of the seller and was not a separate entity, subsidiary, 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;
- 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;
- interest expense may only be excluded from the statements if the debt to which the interest expense relates will not be assumed by the registrant or its subsidiaries consolidated;
- the statements of revenues and expenses do not omit selling, distribution, marketing, general and administrative, and research and development expenses incurred by or on behalf of the acquired business during the periods to be presented; and
- the notes to the financial statements include certain additional disclosures specified in the release.

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

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

- 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 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 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 proposed amendments would also expand the use of, or reconciliation to, International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”). Specifically, both domestic and foreign registrants would be permitted to use IFRS-IASB in Rule 3-05 Financial Statements without requiring reconciliation to U.S. GAAP if the acquired business would otherwise qualify to use IFRS-IASB if it were a registrant.⁸ Similarly, the proposal would permit registrants providing Rule 3-05 Financial Statements of a foreign business prepared on a basis of accounting other than U.S. GAAP or IFRS-IASB to reconcile such financial statements to IFRS-IASB rather than U.S. GAAP if the acquired business would otherwise qualify to use IFRS-IASB if it were a registrant.

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

A. ACQUISITIONS OF “MAJOR SIGNIFICANCE” AND RULE 3-05 FINANCIAL STATEMENTS NOT PREVIOUSLY FILED

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, an acquired business that exceeds at the 80% level the significance threshold under any Rule 1-02(w) significant subsidiary test.

The proposed amendments would eliminate each of these exceptions on the basis of the SEC’s belief that inclusion of the post-acquisition results in the registrant’s financial statements for a complete fiscal year 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 proposed amendments would 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.

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%

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significance level. The current rules also require registrants to provide related pro forma financial information under Article 11 in such circumstances.

The proposed amendments would continue to require disclosure if the aggregate impact of businesses of the acquired or to be acquired businesses exceeds the 50% significance level, however, the pre-acquisition historical financial statements and the related pro forma financial information depicting the aggregate effects of all such acquisitions would only be required for those businesses whose individual significance exceeds 20% and as to which financial statements are not yet required to be filed.

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, reflecting 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 tailor the presentation of pro forma financial information with a goal of eliciting disclosures that distinguish between the one-time impact and the on-going 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 easily applied and, in practice, result in pro forma financial adjustments that are inconsistent even for similar fact patterns.⁹

To address these concerns, the proposals would eliminate the existing adjustment criteria and instead permit adjustments in two principal categories: “Transaction Accounting Adjustments” and “Management’s Adjustments.” Transaction Accounting Adjustments would reflect only the application of required accounting for the acquisition transaction under U.S. GAAP or IFRS-IASB, whereas Management’s Adjustments would provide flexibility for the registrant to include forward-looking information depicting the synergies and other transaction effects of the acquisition in the pro forma financial information. To provide investors with a means to distinguish Management’s Adjustments from the Transaction Accounting Adjustments, registrants would be required to present a separate column in the pro forma financial information reflecting only the incremental Management’s Adjustments.

Additionally, to avoid the inconsistent application of adjustments present under the current rules, the proposed amendments would limit the scope of permitted Management’s Adjustments to only synergies and transaction effects that are reasonably estimable and that have occurred or those that are reasonably expected to occur. Examples cited in the release include closing facilities, discontinuing product lines,

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terminating employees, and executing new or modifying existing agreements. The proposed rules, however, would require registrants to provide, in the explanatory notes to the pro forma financial information, qualitative disclosure of synergies or transaction effects that are not reasonably estimable if such disclosure would be important to investors.

The proposed amendments include a number of additional clarifying changes, which among other items, would explicitly require the registrant to provide: (i) accompanying explanatory notes to the pro forma financial information; (ii) disclosure regarding each Management Adjustment made to the pro forma financial information presented; and (iii) separate columnar information for each transaction for which pro forma effects are required to be presented.

We assume that the inclusion of synergies and transaction effects in the manner proposed in the release will, at least initially, slow the preparation of pro forma financial information following the announcement of an acquisition and, accordingly, delay the filing of Form S-4 registration statements for mergers that require pro forma financial information. 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. Under the proposed rules, acquirors would be required to make their estimates public in a Form S-4 registration statement containing pro forma information. While it is difficult to predict the affect of these disclosures on appraisal litigation in cash/stock transactions, they will be of interest to shareholders as they consider appraisal claims. Further, plaintiffs' lawyers may be expected to focus on these synergies in their review of merger proxy statements.

B. SIGNIFICANCE THRESHOLD FOR DISPOSED BUSINESSES

Rule 11-01 currently requires a registrant to provide certain pro forma financial information for significant 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 proposed amendments would revise the significance threshold under Rule 11-01 to 20%. Further, the proposed amendments conform the significance tests for disposed businesses to the changes proposed 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 PROPOSED 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

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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 proposed a number of amendments to Rule 3-14 in order to conform the rule with the proposed amendments to Rule 3-05 discussed in Sections I and II above. Among other conforming changes, the proposed amendments would:

- apply an explicit 20% significance threshold to Rule 3-14;
- 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 a complete fiscal year.

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 proposes 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 proposed amendments also include revisions to Rule 3-14 that would require Rule 3-14 Financial Statements for the most recent year-to-date interim period prior to the acquisition¹⁰ and clarify that the investment test for determining the significance of real estate operations compares the registrant's investment in the real estate operation, 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.¹¹

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 proposing amendments to Regulation S-X that are designed to tailor the financial reporting

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requirements of registered investment companies and business development companies.¹² The SEC is also proposing related changes to Form N-14 to conform the form's disclosure requirements to the newly proposed 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 proposing new Rule 1-02(w)(2) to create a separate definition of "significant subsidiary" that is tailored for investment companies and is also proposing related amendments to Rule 8b-2 to conform it to new Rule 1-02(w)(2). In summary, the new rules would reflect an income test and an investment test that resemble, but modify, the existing tests set forth in Rule 8b-2. The proposal would 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 proposed investment test for investment companies would compare the value of the registrant's and its other subsidiaries' investment in and advances to the tested subsidiary to the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year. The value of the registrant's total investments would 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 proposed 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 would more appropriately focus 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. This proposed income test applicable to investment companies would modify the numerator of this test to include: (i) investment income, such as 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 sum of the absolute value 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 subsidiaries consolidated 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

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company and its subsidiaries consolidated for the most recently completed fiscal year and the Investment Test condition exceeds 5%.¹³ The proposed rule would permit an investment company that has an insignificant change in net assets resulting from operations for its most recently completed fiscal year to compute the test using the average of the absolute value of such amounts for the registrant and its subsidiaries consolidated for each of its last five fiscal years.

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

The release proposes new Rule 6-11 of Regulation S-X, which would modify the existing requirements applicable to financial reporting for acquired funds¹⁴ under Rule 3-05 and Rule 3-14 in a manner that is tailored to investment companies and their investors. Among other items, proposed Rule 6-11 would require:

- only one year of audited financial statements for fund acquisitions (as opposed to the existing requirement to provide up to three years of Rule 3-05 Financial Statements);
- filing of Article 12 schedules for the acquired fund;¹⁵ and
- consideration of an acquisition of a group of related funds as a single acquisition, with an option for the registrant to present the required financial statements on an individual or combined basis for the periods under which the related funds are under common control or management.

Consistent with the approach under Rule 3-05 applicable to non-investment companies, Rule 6-11 would replace each reference to the significance threshold of 10% under new Rule 1-02(w)(2) with a 20% threshold.¹⁶ Financial statements of the acquired fund would be required if either of the investment or income tests 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, proposed Rule 6-11 would require 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 proposed rule would also permit the use of pro forma financial information in significance calculations to give effect to recent acquisitions under certain circumstances, consistent with the proposed 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 proposal would eliminate the current requirements for investment company registrants to provide pro forma financial information and would instead require certain supplemental disclosures. The supplemental information would include: (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

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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 newly combined entity.

REQUEST FOR COMMENT

The release encourages general comments on any aspect of the proposals, including suggestions for additional changes. In addition to this general request, the release also includes a series of specific questions, many of which contain multiple parts, relating to each of the areas of proposed amendments. Comments are due by the date that is 60 days after publication of the release in the Federal Register.

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ENDNOTES

- 1 See Section II.B for proposed amendments regarding the number of periods for which Rule 3-05 Financial Statements need be presented.
- 2 The SEC is also proposing amendments to the significance tests applicable in the context of investment companies, as described further in Section V.A.
- 3 To preserve consistency, the SEC's proposed changes to Rule 1-02(w) would also revise the significance tests under other rules that rely on the Rule 1-02(w) "significant subsidiary" test.
- 4 To determine the number of periods for which Rule 3-05 Financial Statements are required, the proposal would require the registrant to use the lower of the significance calculation from the revenue component and the net income component.
- 5 See Section II.A for proposed revisions to this component of Rule 3-05.
- 6 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.
- 7 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 proposed a new Rule 3-05(f) to codify these reporting practices when certain conditions are satisfied.
- 8 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.
- 9 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.
- 10 Currently, unlike Rule 3-05, Rule 3-14 does not include an express requirement for registrants to provide interim financial information.
- 11 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.
- 12 The release notes that because securities from acquired funds become part of the acquiring fund's investment portfolio, the concept of a disposition of a business is inapt for investment companies.
- 13 While the significant subsidiary test applicable to investment companies under Rule 1-02(w)(2) would include this 10% significance threshold, this threshold would be replaced with a 20% significance threshold for purposes of evaluating the significance of acquired funds under proposed new Rule 6-11, to conform to the 20% significance test on comparable conditions in current Rule 3-05.
- 14 For purposes of Rule 6-11, "fund" includes any investment company as defined in Section 3(a) of the Investment Company Act, any private fund that would otherwise be an investment company but for the exclusions provided in section 3(c)(1) or 3(c)(7) of the Investment Company Act, or

ENDNOTES (CONTINUED)

- any private account managed by an investment advisor. In the case of an acquisition of a private account, only the Article 12 schedules are proposed to be required.
- ¹⁵ Article 12 schedules for the acquired fund require each investment of the fund to be listed separately. While the proposed rule would permit 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 would need to accompany the U.S. GAAP financial information for investors to obtain all material information.
- ¹⁶ See Section V.A for a discussion of new Rule 1-02(w)(2).

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CONTACTING SULLIVAN & CROMWELL LLP

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CONTACTS

New York

Francis J. Aquila	+1-212-558-4048	aquilaf@sullcrom.com
Ari B. Blaut	+1-212-558-1656	blauta@sullcrom.com
Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Catherine M. Clarkin	+1-212-558-4175	clarkinc@sullcrom.com
Audra D. Cohen	+1-212-558-3275	cohenad@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
Scott B. Crofton	+1-212-558-4682	croftons@sullcrom.com
Robert G. DeLaMater	+1-212-558-4788	delamaterr@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
John E. Estes	+1-212-558-4349	estesj@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Brian E. Hamilton	+1-212-558-4801	hamiltonb@sullcrom.com
Matthew G. Hurd	+1-212-558-3122	hurdm@sullcrom.com
Alexandra D. Korry	+1-212-558-4370	korrya@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
John P. Mead	+1-212-558-3764	meadj@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com

SULLIVAN & CROMWELL LLP

Keith A. Pagnani	+1-212-558-4397	pagnanik@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
George J. Sampas	+1-212-558-4945	sampasg@sullcrom.com
Melissa Sawyer	+1-212-558-4243	sawyerem@sullcrom.com
James M. Shea Jr.	+1-212-558-4924	sheaj@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com
Krishna Veeraraghavan	+1-212-558-7931	veeraraghavank@sullcrom.com
Benjamin H. Weiner	+1-212-558-7861	weinerb@sullcrom.com

Washington, D.C.

Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com
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Los Angeles

Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Rita-Anne O'Neill	+1-310-712-6698	oneillr@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com

Palo Alto

Scott D. Miller	+1-650-461-5620	millersc@sullcrom.com
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com

London

Chris Beatty	+44-20-7959-8505	beattyc@sullcrom.com
Kathryn A. Campbell	+44-20-7959-8580	campbellk@sullcrom.com
Oderisio de Vito Piscicelli	+44-20-7959-8589	devitopiscicellio@sullcrom.com
John Horsfield-Bradbury	+44-20-7959-8491	horsfieldbradburyj@sullcrom.com
John O'Connor	+44-20-7959-8515	oconnorj@sullcrom.com
Evan S. Simpson	+44-20-7959-8426	simpsons@sullcrom.com

Paris

William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
----------------------	-----------------	--

Frankfurt

Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
---------------------	------------------	--

Sydney

Waldo D. Jones Jr.	+61-2-8227-6702	jonesw@sullcrom.com
--------------------	-----------------	--

Tokyo

Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com

SULLIVAN & CROMWELL LLP

Hong Kong

Garth W. Bray	+852-2826-8691	brayg@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Ching-Yang Lin	+852-2826-8606	linc@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com

Beijing

Gwen Wong	+86-10-5923-5967	wonggw@sullcrom.com
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