January 13, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant (File No. S7-20-15)

Dear Mr. Fields:

We write to provide our perspectives on the Securities and Exchange Commission's ("SEC"" or the "Commission") "*Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant*".

We focus our comments primarily on two aspects of the Request for Comment: (1) financial information disclosure requirements for acquired businesses, and (2) required disclosures for subsidiaries not consolidated and 50 percent or less owned persons. We recognize that the subjects in the Request for Comment are technical, but nonetheless potentially important to investors. We appreciate the Commission's efforts to present the material in an accessible manner, as well as the Commission's desire to provide more useful disclosures around these topics.

Overview

We support the goal of making disclosure more useful and effective to shareholders and investors. Effectiveness can be enhanced by eliminating duplicative disclosure, improving the mechanisms for cost effective delivery, and improving the overall quality of information required to be disclosed.

With respect to the possible changes to Regulation S-X relating to the use of pro forma financial information ("Pro Forma Information") in business combinations, we note that only two comment letters addressed this issue.[1] The only letter to do so from the perspective of users indicated that "this is a lower priority for users in terms of improving disclosure effectiveness."[2]

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[1] The Division received over 50 letters through the date of the release, with only two mentioning the issue. *See* Exchange Act Release No. 75985 (Sept. 25, 2015) ("Two of the comment letters addressed Regulation S-X"). The comment letters are here: http://www.sec.gov/comments/disclosure-effectiveness/disclosureeffectiveness.shtml

[2] *See* Letter from Sandra J. Peters & James C. Allen, Standards & Financial Markets Integrity Division, CFR Institute, Nov. 12, 2014, available at http://www.sec.gov/comments/disclosure-effectiveness/disclosureeffectiveness-24.pdf The other letter came from the Disclosure Effectiveness Working

While we appreciate that Rule 3-05 of Regulation S-X "has not been thoroughly reconsidered since 1996"[3] we believe that future efforts with respective to disclosure effectiveness should be driven primarily by concerns and priorities identified by shareholders and investors.

In that regard, we are concerned with some of the questions posed in the Release. The Release asks whether the pro forma disclosure should be eliminated or replaced. Concerns over the value of the Pro Forma Information are traceable at least in part to the limitations imposed by the staff at the Commission on the content of this Information and on the delay in its distribution. The focus going forward should not be on elimination but on changes that will improve the quality of Pro Forma Information and its usefulness to investors.

Financial Information Disclosure Requirements for Acquired Businesses

Our understanding is that Rule 3-05 of Regulation S-X ("Rule 3-05") requires a registrant to file separate audited pre-acquisition financial statements (annual) for an acquired business if that business is significant to the registrant.[4] In addition, Pro Forma Information is required, including adjustments designed to present the combined financial statements as if the acquisition had occurred at the beginning of the first fiscal year presented. Among the features of these requirements are the following: (1) certain adjustments to the Pro Forma Information are prohibited, even if those adjustments may serve to more accurately present the financial status of the combined entity as if the acquisition had occurred at an earlier date,[5] (2) only one year of Pro Forma Information is presented, and (3) the Pro Forma Information is not due to be filed until 75 days after the acquisition.

As an initial comment, we note that the Release referenced somewhat dated criticism questioning the need for pre-acquisition financial statements[6] while conceding that "some of these concerns" were addressed in the Pro Forma Information. The ability of Pro Forma Information to address these concerns was, however, limited by "restrictions" that prohibited "a registrant from reflecting other significant changes it expects to result from the acquisition."[7] As we discuss

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Group of the Federal Regulation of Securities Committee and the Law and Accounting Committee of the American Bar Association. *See* Letter from Thomas J. Kim, Chair, Disclosure Effectiveness Working Group of the Federal Regulation of Securities Committee and the Law and Accounting Committee, Business Law Section, American Bar Association, November 14, 2014, *available at* http://www.sec.gov/comments/disclosureeffectiveness/disclosureeffectiveness-23.pdf

[3] Exchange Act Release No. 75985 n. 15 (Sept. 25, 2015).

[4] Unaudited pre-acquisition interim financial statements are also required for the acquired business.

[5] More technically, pro forma adjustments need to be: (1) directly attributable to the transaction, (2) continue to affect the registrant, and (3) factually supportable. As a result of these requirements, particularly item #3, certain adjustments that may provide the most meaningful information with respect to future operating results and financial position are prohibited.

[6] Exchange Act Release No. 75985 (Sept. 25, 2015) (noting that commenters writing "[p]rior to the adoption of Rule 3-05 in 1982. . . criticized the utility and relevance of pre-acquisition financial statements in assessing the future impacts of an acquisition on a registrant.").

[7] Exchange Act Release No. 75985 (Sept. 25, 2015) ("Although the Pro Forma Information addresses some of these concerns by showing how the accounting for an acquisition might have affected a registrant's historical financial

below, "disclosure effectiveness" should focus not on the elimination of pre-acquisition financial statements but on changes to staff interpretation that have prevented the Pro Forma Information from fully addressing any concerns with pre-acquisition financial statements.

The Pro Forma Information required under Item 3-05 for the most part is backward looking. They are designed to "show how the acquisition might have affected those financial statements had it occurred at an earlier time."[8] In general, they must include the most recent fiscal year and any interim periods.

To accurately illustrate the effect of the acquisition, however, the financial statements must include adjustments that reflect the consequences of the combination.[9] Adjustments may only be made, however, if "factually supportable" and "directly attributable to the transaction."[10] In construing these standards, the staff has largely limited adjustments to those arising out of contractual obligations or other firm commitments.[11]

As a result of this approach, adjustments cannot include "future synergies and cost savings that are not expressly mandated by the acquisition documents"[12] or savings arising from economies of scale.[13] They cannot include anticipated financing,[14] anticipated improvements in interest

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statements had the transaction been consummated at an earlier time, restrictions on pro forma adjustments prohibit a registrant from reflecting other significant changes it expects to result from the acquisition.").

[8] Exchange Act Release No. 75985 (Sept. 25, 2015).

[9] In re Leedy, Wheeler & Co., 16 SEC 299 (July 27, 1944) ("A *pro forma* balance sheet does not portray the actual financial condition of an enterprise. It is a statement based on a balance sheet taken from the books of account, but adjusted to incorporate various hypothetical transactions which have not in fact occurred at the date of the balance sheet, but whose occurrence is contemplated.").

[10] § 210.11-02(b) (6).

[11] *See* Wright Express Corp., SEC Staff Comment Letter, March 10, 2006 (matters are not factually supportable unless "supported by written contracts, employment agreements, or other contractual arrangements that have been finalized rather than on the basis of vendor quotes or estimates"). *See also* Pro Forma Information, Manual § 10.400, SEC Accounting and Reporting Manual, WGL Acct. & Rep. (2015) ("The term 'factually supportable' is generally interpreted by the SEC staff to mean virtually the same as 'contractual' or as requiring similar persuasive evidence.").

[12] Your Guide to Rule 3-05 of Regulation S-X, Part 3, Latham & Watkins, Oct. 17, 2011, available at http://www.wowlw.com/financial-statement-requirements/as-you-may-recall-weve/

[13] Pro Forma Financial Information, Manual § 10.400, SEC Accounting and Reporting Manual, WGL Acct. & Rep. (2015) ("Expected cost savings resulting from economies of scale should not be reflected through adjustments as they would be merely incidental, not directly attributable, to the transaction.").

[14] Santa Maria Energy Corp., SEC Staff Comment Letter, May 6, 2014 ("We note . . . that you 'have not yet secured agreements or commitments to any financing at this time' although indicating you may have such arrangements prior to mailing the joint proxy/prospectus to investors. Please understand that until you have secured financing agreements that cover the range of possibilities depicted in two of your pro forma scenarios, those presentations do not conform with the 'factually supportable' criteria of Rule 11-02(b)(6) of Regulation S-X.").

rates,[15] changes in compensation,[16] or other cost savings[17] absent actual commitments. Likewise they may not include savings arising out of workforce reductions or facility closings.[18] Acquirers generally cannot use "effective" tax rates but must rely on the "statutory" rate.[19] As one treatise concluded, the standard of directly attributable precludes "adjustments for planned, hoped for, or expected changes in the results of operations."[20] The approach sometimes results in Pro Forma Information failing to adequately inform investors about the consequences of an acquisition.

The staff should, therefore, alter the existing approach with respect to pro forma financials under Rule 3-05.[21] Rather than view this requirement as an opportunity to provide historical information, Pro Forma Information should be reimaged to require management to show how all material assumptions about the financial impact of the acquisition apply in practice.[22] Pro Forma Information should be required to reflect all significant assumptions made by the acquirer and

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[15] One Gas, Inc., SEC Staff Comment Letter, Feb. 26, 2014 ("If you can support that the amount of debt is factually supportable and objectively determinable, you should explain how an interest rate based on an assumed investment grade credit rating and an approximate credit spread over the relevant benchmark rate is factually supportable and objectively determinable. Generally, we believe pro forma interest rates should be based on either your current interest rate or the interest rate for which you have a commitment.").

[16] SAB 45, May 20, 1982 ("Under these circumstances, the financial statements of the combined enterprise may be supplemented with a pro forma financial presentation which shows the effects of salary changes that are supported by employment agreements.").

[17] Pro Forma Information, Manual § 10.400, SEC Accounting and Reporting Manual, WGL Acct. & Rep. (2015) ("Where cost savings are directly attributable to the transaction, factually supportable, and expected to have a continuing impact, they may be reflected as a pro forma adjustment. An example is where the acquiring entity achieves long-term contractual adjustments to labor or materials costs, such as through amendments to a labor contract or supply agreement, in conjunction with and as a part of the acquisition.").

[18] Exchange Act Release No. 75985 (Sept. 25, 2015) ("For example, Commission staff has stated that workforce reductions and facility closings, both actions that registrants frequently take when acquiring businesses, are generally too uncertain to meet the criteria for adjustment."). *See also* Section 3310.3, Financial Reporting Manual, Division of Corporation Finance, SEC (adjustments not permitted in pro forma financial statements include "[p]ro forma adjustments that give effect to actions taken by management or expected to occur after a business combination, including termination of employees, closure of facilities, and other restructuring charges. Forecasts or projections may be the most appropriate way to depict the effect of such actions."), available at https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf#topic3

[19] Standard Parking Corp., SEC Staff Comment Letter, March 11, 2013 ("Reference is made to note (5) where you indicate that the provision for income tax related to the pro forma adjustments utilizes the effective tax rates of each of the entities. However, Article 11 of Regulation S-X states that the statutory tax rate should be used to calculate the income tax effect of pro forma adjustments. However, different tax rates may be used only if they are factually supportable. In this regard, please revise your pro forma tax adjustment utilizing the statutory rate or advise us how the rate used is factually supportable."). *See also* Instruction 7 of Article 11-02 of Regulation S-X ("7. Tax effects, if any, of pro forma adjustments normally should be calculated at the statutory rate in effect during the periods for which pro forma condensed income statements are presented and should be reflected as a separate pro forma adjustment.").

[20] Pro Forma Financial Information, Manual § 10.400, SEC Accounting and Reporting Manual, WGL Acct. & Rep. (2015).

[21] Pro Forma Information included in registration statements in connection with the issuance of shares or in proxy statements in connection with shareholder action may require different considerations.

[22] Pro Forma Financial Information, Manual § 10.400, SEC Accounting and Reporting Manual, WGL Acct. & Rep. (2015) ("Associated with this concept is the SEC's view that pro forma financial information is essentially historical rather than prospective financial information. The staff will not allow a pro forma income statement to serve as a forecast. If a registrant would prefer to show the reader the expected results of operations, it may elect under Rule 11-03 to present a financial forecast.").

show the effect of these assumptions had they been in place the prior fiscal year.[23] Disclosure of such assumptions would need to appear in the footnotes.

The approach will benefit investors. Acquiring companies often disclose anticipated cost savings and expected synergies when announcing an acquisition. Pro forma financials that illustrated these savings on the basis of the prior year's financial statements would provide investors with a better understanding of how management expected these savings to apply in practice.

We understand that increased discretion to make adjustments can be abused. Acquiring companies may sometimes reflect an overly optimistic view of the benefits of an acquisition. The additional flexibility in creating Pro Forma Information should, therefore, be accompanied by increased disclosure. All significant assumptions and adjustments should be disclosed in the footnotes to the financial statements.

In addition, the Pro Forma Information should be accompanied by management's discussion and analysis ("MD&A"). The MD&A would provide a narrative discussion of all significant adjustments, including cost savings, synergies, and other less certain adjustments. The MD&A should also separately break out and discuss each assumption, synergy or adjustment so that investors can understand more clearly the individual impact that each has on the Pro Forma Information.

The disclosure would be subject to the antifraud provisions.[24] Adjustments that rendered the Pro Forma Information misleading could, therefore, make the statements actionable.[25] Actions under the antifraud provisions could apply, for example, to undisclosed assumptions or unreasonable estimates.[26]

We further recommend that issuers be required, in subsequent filings, to disclose any material change in assumptions or estimates. The requirement will provide investors with useful

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[23] Issuers are already permitted to include certain adjustments in the footnotes but not the pro forma financial statements. *See* Section 3310, Financial Reporting Manual, Division of Corporation Finance, SEC, available at https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf#topic3 (specifying adjustments that are generally "not appropriate on the face of the respective pro forma financial statements, but could be disclosed in the footnotes"). We propose that use of the assumptions be mandatory and that the assumptions appear in both the pro forma financial statements and footnotes.

[24] *See* Exchange Act Release No. 45124 (Dec. 4, 2001) ("we are concerned that "pro forma" financial information, under certain circumstances, can mislead investors if it obscures GAAP results. Because this "pro forma" financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies.").

[25] *See* Exchange Act Release No. 45124 (Dec. 4, 2001) ("the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information. Because "pro forma" information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information.").

[26] *See In re Leedy, Wheeler & Co.*, 16 SEC 299 (July 27, 1944) ("Since such a balance sheet does not purport to portray the actual financial condition of a company at the balance sheet date, it is plainly necessary that it indicate the assumptions which underlie its preparation, so that one examining the statement will be fully apprised as to which items in it are based on fact and which on assumption. Without such disclosure a pro forma statement is meaningless and deceptive.").

information about the actual effects of the acquisition and will likely encourage greater precision in the development of estimates and assumptions.

Any resulting change to make more extensive the Pro Forma Information required by Rule 3-05 must be accompanied by significant auditor involvement in attesting to the reasonableness of the adjustments, including verifying that these adjustments are accurately reflected in the Pro Forma Information. Although an existing framework exists for such auditor reporting (AT 401 – *Reporting on Pro Forma Financial Information*), the existing framework represents guidance previously promulgated by the AICPA's Auditing Standards Board that the PCAOB adopted as an interim standard in 2003. The guidance in AT 401 remains in effect, and we support any effort by the PCAOB to examine whether the existing standard for auditor reporting on pro forma financial information can be improved. Moreover, although guidance exists for auditors in auditing pro forma financial information, there is little guidance, SEC or otherwise, for how to prepare the information. We believe that this lack of guidance chills the presentation of more meaningful pro forma information, and should be addressed by the SEC.

Finally, we urge the Commission to revisit the 75 day time period for the filing of Pro Forma Information under Rule 3-05. The relevant assumptions and estimates made with respect to an acquired company are presumably known upon completion of the acquisition. Particularly with respect to the acquisition of a public company, the 75 day period is unnecessary[27] and should be shortened.[28] More rapid disclosure of the information will facilitate the use of the information by shareholders and investors in making investment decisions.[29]

Required Disclosures for Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons

If a registrant owns less than 50% of another entity, and that entity is significant as defined by the income and investment tests as specified in Rule 1-02(w) of Regulation S-X, than the registrant is required to file separate audited or unaudited (depending on how significant the investee is to the registrant) financial statements (hereafter referred to as Rule 3-09 of Regulation

[27] The Release notes that the delay in disclosure is "intended to provide sufficient time to obtain the Rule 3-05 Financial Statements and prepare the Pro Forma Information."

[28] Private companies may also have audited financial statements already available. *See* Letter from Crowe Horwath to SEC, Re: File No. S7-20-15 (Nov. 30, 2015) ("In some cases, audited financial statements of an acquired or to be acquired private company might already be available. The company might have already provided its audited financial statements to shareholders, creditors and other users, using a widely accepted accounting framework (e.g. U.S. GAAP).").

[29] *See* Letter from Davis Polk to SEC, Re: File No. S7-20-15 (Nov. 30, 2015)("Fundamentally, we believe that in many instances the financial statements required under Rule 3-05 do not provide information that is needed by a "reasonable investor" in making an investment decision. Notably, the equity markets trade without the information included in the financial statements from the signing of a definitive agreement until 75 days following the acquisition. During this period, investors are evaluating and making investment decisions without the aid of this information and do not appear to fundamentally misjudge the effect of an acquisition even without the financial metrics mandated by Rule 3-05.").

S-X ("Rule 3-09") financial statements). These financial statements would be included in the registrant's Form 10-K (and, if applicable, registration statements).[30]

In addition, if investees in the aggregate meet certain size tests, then summarized balance sheet and income statement information, aggregated across all investees, is presented in the notes to the financial statements under Rule 4-08(g) of Regulation S-X. It is important to note that the financial statements of significant investees can be prepared using different accounting standards, fiscal year ends, and reporting currencies than those used by the registrant.

We believe that detailed financial information about significant investees is meaningful to investment and stewardship purposes. If a registrant owns more than 20 percent and less than 50 percent of an investee, GAAP generally views the registrant as possessing significant influence over the investee although not outright control. There has been debate over the years as to whether a 50 percent ownership threshold is truly needed to have effective control, but notwithstanding the merits of that debate an ownership threshold of between 20 and 50 percent is quite significant both from the perspective of voting influence and economic interest. Investees may present very different profiles from the registrant with respect to risk, profitability, growth, etc. Providing investors with detailed financial information about significant investees allows them to assess these characteristics.

Notwithstanding the importance of providing detailed financial information on significant investees, we share the Commission's desire to provide more useful information for investment and stewardship purposes. We believe that it may be possible to craft disclosures in this area where Rule 3-09 financial statements for significant investees, including summarized balance sheet and income statement information (aggregated across investees), is replaced with more detailed financial information for significant investees, presented separately for each significant investee, and which would appear in the notes to the financial statements. Given that this information would comprise part of the audited financial statements, this detailed financial information would be subject to audit, which we view as a desirable outcome.

Other Comments

Although we have chosen not to respond to the myriad of questions included in the Request for Comment, we do want to comment on two questions in particular.

With respect to Rule 3-05, question #14 asks whether the Commission should require foreign private issuers to provide disclosures similar to those provided by domestic registrants. We believe that the disclosure regime for all SEC registrants should be as similar as possible. Disclosure requirements for foreign private issuers should only differ when there is a compelling justification for such a difference. Given that information on a business being acquired would seem as germane whether the registrant is domestic or foreign, and not being aware of any compelling reason as to why this disclosure requirement poses a disproportionate burden for a

[30] Regulation S-X also requires the disclosure of summarized income statement information for significant investees and would appear in the Form 10-Q.

foreign private issuer, we believe that the disclosure requirements with respect to acquired businesses should be harmonized to the extent possible.

Question #58 broaches the issue of how required information should be presented. The question contemplates a disclosure regime based on summarized information, but much more detailed information would also be required and could easily be accessed by those investors desiring greater detail and specificity in one or more areas. This question goes far beyond this project, but we believe that the SEC should explore a more tailored disclosure regime, perhaps one based on a series of links or tabs where each successive link or tab provides the user with ever more refined detail and specificity. Such a disclosure regime would move financial disclosure toward a world of "mass customization", a world that seems achievable, and desirable, given the tremendous technological tools available today.

Empowering Investors

The Commission's approach in revising regulation S-X should be designed to provide shareholders and investors with the information needed to make their own investment decisions. By improving the quality of the Pro Forma Information to better understand the assumptions made by acquiring companies, investors will have greater ability to assess the quality of an acquisition. Moreover, shortening the period for disclosure of the Pro Forma Information will better ensure that investors obtain the information on a timely basis.

We appreciate the opportunity to comment on this proposal.

With regards.

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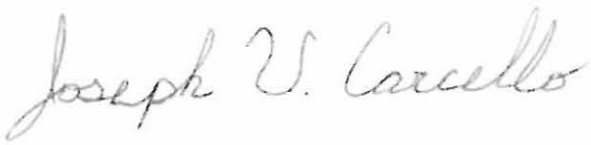

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