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**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 210, 230, 239, 240 249, 270, and 274**

**[Release No. 33-10635; 34-85765; IC-33465; File No. S7-05-19]**

**RIN 3235-AL77**

**Amendments to Financial Disclosures about Acquired and Disposed Businesses**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** We are proposing amendments to our rules and forms to improve the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses, including real estate operations and investment companies. The proposed changes are intended to improve for investors the financial information about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure.

**DATES:** Comments should be received on or before July 29, 2019.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic comments:*

- Use our Internet comment form (<http://www.sec.gov/rules/other.shtml>);
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-05-19 on the subject line; or

*Paper comments:*

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-05-19. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method of submission. We will post all comments on our website (<http://www.sec.gov/rules/other.shtml>). Comments also are available for website viewing and printing in our Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

We or the staff may add studies, memoranda, or other substantive items to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on our website. To ensure direct electronic receipt of such notifications, sign up through the “Stay Connected” option at [www.sec.gov](http://www.sec.gov) to receive notifications by e-mail.

**FOR FURTHER INFORMATION CONTACT:** Todd E. Hardiman, Associate Chief Accountant, at (202) 551-3516, or Jessica Barberich, Associate Chief Accountant, at (202) 551-3782 or Craig Olinger, Senior Advisor to the Chief Accountant, at (202) 551-3400, or Steven G. Hearne, Senior Special Counsel at (202) 551-3430 in the Division of Corporation Finance; Jenson Wayne, Assistant Chief Accountant, at (202) 551-6918, or Mark T. Uyeda, Senior Special Counsel, at (202) 551-6792, in the Division of Investment Management, 100 F Street, NE, Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:**

The Commission is proposing to amend:

Commission Reference		CFR Citation (17 CFR)
Regulation S-X	Rules 1-01 <i>et seq.</i>	§ 210.01 <i>et seq.</i>
	Rule 1-02(w)	§ 210.1-02(w)
	Rule 3-05	§ 210.3-05
	Rule 3-06	§ 210.3-06
	Rule 3-14	§ 210.3-14
	Rule 3-18	§ 210.3-18
	Rule 5-01	§ 210.5-01
	Rule 6-01	§ 210.6-01
	Rule 6-02	§ 210.6-02
	Rule 6-03	§ 210.6-03
Article 8	Rule 8-01	§ 210.8-01
	Rule 8-03	§ 210.8-03
	Rule 8-04	§ 210.8-04
	Rule 8-05	§ 210.8-05
	Rule 8-06	§ 210.8-06
Article 11	Rule 11-01	§ 210.11-01
	Rule 11-02	§ 210.11-02
	Rule 11-03	§ 210.11-03
Securities Act of 1933 (Securities Act) <sup>1</sup>	Securities Act Rule 405	§ 230.405
	Rule 405 of Regulation S-T	§ 232.405
	Form N-2	§ 239.14 and § 274.11a-1
	Form N-14	§ 239.23
Securities Exchange Act of 1934 (Exchange Act) <sup>2</sup>	Rule 12b-2	§ 240.12b-2
	Rule 14a-101	§ 240.14a-101
	Form 8-K	§ 249.308
	Form 10-K	§ 249.310
Investment Company Act of 1940 (Investment Company Act) <sup>3</sup>	Rule 8b-2	§ 270.8b-2

We also are proposing to add 17 CFR § 210.6-11 (new “Rule 6-11”) to Regulation S-X.

<sup>1</sup> 15 U.S.C. 77a *et seq.*

<sup>2</sup> 15 U.S.C. 78a *et seq.*

<sup>3</sup> 15 U.S.C. 80a-1 *et seq.*

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## I. Introduction and Background

We are proposing changes to the requirements for financial statements relating to acquisitions and dispositions of businesses, including real estate operations, in Rule 3-05,<sup>4</sup> *Financial Statements of Businesses Acquired or to be Acquired*, Rule 3-14, *Special Instructions for Real Estate Operations to be Acquired*, Article 11, *Pro Forma Financial Information of Regulation S-X* and other related rules and forms.<sup>5</sup> We are also proposing new Rule 6-11 of Regulation S-X and amendments to Form N-14 to specifically govern financial reporting for acquisitions involving investment companies. The proposed amendments are intended to improve for investors the financial information about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure.<sup>6</sup>

This proposal results from an ongoing, comprehensive evaluation of our disclosure requirements.<sup>7</sup> As part of this evaluation, in September 2015, the Commission issued a Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the

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<sup>4</sup> Unless otherwise noted, references in this release to “Rule” or “Rules” are to the rules under Regulation S-X.

<sup>5</sup> We are also proposing related amendments in Regulation S-X to the definition of *significant subsidiary* in Rule 1-02(w); Rule 3-06, *Financial statements covering a period of nine to twelve months*; and Article 8, *Smaller Reporting Companies*. In addition, we are proposing amendments to Form 8-K for current reports, Form 10-K for annual and transition reports, and the definition of *significant subsidiary* in Rule 12b-2 under the Exchange Act, Rule 405 under the Securities Act, and Rule 8b-2 under the Investment Company Act.

<sup>6</sup> The proposed amendments would not apply to financial statements related to the acquisition of a business that is the subject of a proxy statement or registration statement on Form S-4 (17 CFR 239.25) or Form F-4 (17 CFR 239.34), but would apply to pro forma information provided pursuant to Article 11 and financial information for acquisitions and dispositions otherwise required to be disclosed pursuant to Rule 3-05 or Rule 3-14. These amendments also would not affect the requirements in 17 CFR 210.3-02 (“Rule 3-02”) or 17 CFR 210.8-01 relating to predecessor companies.

<sup>7</sup> The staff, under its Disclosure Effectiveness Initiative, is reviewing the disclosure requirements in Regulation S-X and 17 CFR 229.10 through 1208 (“Regulation S-K”) and is considering ways to improve the disclosure regime for the benefit of both companies and investors. The goal is to comprehensively review the requirements and make recommendations on how to update them to facilitate timely, material disclosure by companies and shareholders’ access to that information. See <https://www.sec.gov/spotlight/disclosure-effectiveness.shtml>.



Registrant (“2015 Request for Comment”).<sup>8</sup> The 2015 Request for Comment sought feedback on, among other things, the financial disclosure requirements in Regulation S-X for certain entities other than the registrant. More specifically, the Commission solicited comment on how investors use the disclosures required by these rules to make investment decisions, the challenges that registrants and others face in providing the required disclosures, and potential changes to these requirements that could enhance the information provided to investors and promote efficiency, competition, and capital formation. We received approximately 50 comment letters discussing Rule 3-05, Rule 3-14, Article 8, and Article 11<sup>9</sup> and these comments were considered carefully in developing these proposals.

When a registrant acquires a business<sup>10</sup> other than a real estate operation, Rule 3-05 of Regulation S-X generally requires a registrant to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business if it is significant to the registrant (“Rule 3-05 Financial Statements”). Recognizing that certain acquisitions have a greater impact on a registrant than others, the Commission adopted Rule 3-05 to address the reporting requirements for businesses acquired or to be acquired based on the significant subsidiary

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<sup>8</sup> *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant*, Release No. 33-9929 (Sept. 25, 2015) [80 FR 59083 (Oct. 1, 2015)].

<sup>9</sup> Comments that we received in response to the 2015 Request for Comment are available at <https://www.sec.gov/comments/s7-20-15/s72015.shtml>. References to comment letters in this release refer to the comments on the 2015 Request for Comment unless otherwise specified.

<sup>10</sup> Rule 3-05 requires disclosure if the “business combination has occurred or is probable.” See 17 CFR 210.3-05(a). Registrants determine whether a “business” has been acquired by applying Rule 11-01(d) of Regulation S-X. The definition of “business” in Regulation S-X focuses primarily on whether the nature of the revenue-producing activity of the acquired business will remain generally the same as before the transaction. This determination is separate and distinct from a determination made under the applicable accounting standards. Because the definitions serve different purposes, we have not proposed to conform our rules with the applicable accounting standards.

definition in Rule 1-02(w) using a sliding scale approach.<sup>11</sup> Rule 3-05 also applies to registrants that are registered investment companies and business development companies. The Commission later adopted Rule 8-04, *Financial Statements of Businesses Acquired or to be Acquired*, in order to provide comparable requirements for smaller reporting companies.<sup>12</sup>

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).<sup>13</sup> These tests generally can be described as follows:

- “Investment Test” - the investment in and advances to the acquired business are compared to the total assets of a registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date;
- “Asset Test” - a registrant’s proportionate share of the acquired business’s total assets reflected in the business’s most recent annual pre-acquisition financial statements is compared to the total assets of the registrant reflected in its most recent annual financial

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<sup>11</sup> *Instructions for the Presentation and Preparation of Pro Forma Financial Information and Requirements for Financial Statements of Businesses Acquired or To Be Acquired*, Release No. 33-6413 (Jun. 24, 1982) [47 FR 29832 (Jul. 9, 1982)] (“Rule 3-05 Adopting Release”). The requirements are based on the significant subsidiary tests using a sliding scale so that the requirements for filing such financial statements as well as the periods covered by such financial statements will vary with the percentage impact of the acquisition on the registrant. In adopting the sliding scale approach, the Commission stated its belief that the selected percentages “meet the objectives of providing adequate financial information to investors, shareholders and other users while at the same time reducing the reporting burdens of registrants involved in acquisitions.”

<sup>12</sup> *Smaller Reporting Company Regulatory Relief and Simplification*, Release No. 33-8876 (Dec. 19, 2007) [73 FR 934 (Jan. 4, 2008)] (“SRC Relief Adopting Release”). For financial disclosure requirements, the SRC Relief Adopting Release predominantly effectuated a relocation of the requirements in 17 CFR 228, Regulation S-B, into Regulation S-K and Regulation S-X.

<sup>13</sup> Rule 3-05 provides for use of a 20% significance threshold, rather than the 10% threshold indicated in Rule 1-02(w). The Commission raised the threshold in Rule 3-05 from 10% to 20% in 1996 in order to reduce compliance burdens in response to concerns that the requirement to obtain audited financial statements for a business acquisition may have caused companies to forgo public offerings in favor of private or offshore offerings. See *Streamlining Disclosure Requirements Relating to Significant Business Acquisitions*, Release No. 33-7355 (Oct. 10, 1996) [61 FR 54509 (Oct. 18, 1996)] (“1996 Streamlining Release”). As a result of this amendment, the significance thresholds in Rule 3-05 diverged from those used for Rule 3-14 and for dispositions at that time.

statements required to be filed at or prior to the acquisition date; and

- “Income Test” - 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 business’s most recent annual pre-acquisition financial statements, is compared 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 date.

If none of the Rule 3-05 significance tests exceeds 20%, a registrant is not required to file Rule 3-05 Financial Statements.<sup>14</sup> If any of the Rule 3-05 significance tests exceeds 20%, but none exceeds 40%, Rule 3-05 Financial Statements are required for the most recent fiscal year and any required interim periods. If any Rule 3-05 significance test exceeds 40%, but none exceeds 50%, a second fiscal year of Rule 3-05 Financial Statements is required. When at least one Rule 3-05 significance test exceeds 50%, a third fiscal year<sup>15</sup> of Rule 3-05 Financial Statements is required unless net revenues of the acquired business were less than \$100 million in its most recent fiscal year.<sup>16</sup> Rule 3-05 Financial Statements are not required 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, unless the financial statements

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<sup>14</sup> Rule 3-05 contains an additional requirement for certain registration statements and proxy statements related to the aggregate effect of individually insignificant businesses, which may trigger a requirement for Rule 3-05 Financial Statements for a business for which none of the significance tests exceed 20%. *See* further discussion at note 118 below.

<sup>15</sup> A smaller reporting company is subject to similar requirements under Rule 8-04 of Regulation S-X, but financial statements are only required for up to two fiscal years.

<sup>16</sup> 17 CFR 210.3-05(b)(2). The revenue threshold to this exception is based on the “smaller reporting company” definition. The threshold was recently increased from \$50 million to \$100 million as part of amendments to the “smaller reporting company” definition. *See Amendments to Smaller Reporting Company Definition*, Release No. 33-10513 (June 28, 2018) [83 FR 31992 (July 10, 2018)] (“2018 SRC Amendments”).

have not been previously filed or the acquisition is of major significance.<sup>17</sup> An acquisition is considered to be of major significance when the acquired business is of such significance to the registrant that omission of Rule 3-05 Financial Statements would materially impair an investor's ability to understand the historical financial results of the registrant; for example, if, at the date of acquisition, the acquired business met at least one of the conditions in the significance tests at the 80% level.

Under Rule 3-14, a registrant that has acquired (and in the case of certain registration statements and proxy statements, proposes to acquire) a significant real estate operation similarly must file financial statements with respect to such operations; however, the required financial statements only include separate audited annual and unaudited interim abbreviated income statements (“Rule 3-14 Financial Statements”).<sup>18</sup> While Rule 3-14 refers to real estate acquisitions that are “significant,” it does not refer specifically to the conditions in the definition of “significant subsidiary” in Rule 1-02(w).<sup>19</sup> Additionally, Rule 3-14 generally only requires one year of Rule 3-14 Financial Statements.<sup>20</sup>

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<sup>17</sup> 17 CFR 210.3-05(b)(4)(iii).

<sup>18</sup> See Rule 3-14. Rule 3-14 was adopted as part of the Commission’s effort to establish a centralized set of instructions in Regulation S-X and is based on the disclosure requirements in Item 6(b) for Form S-11 (17 CFR 239.18) as adopted in 1961. See *Uniform Instructions as to Financial Statements—Regulation S-X*, Release No. 33-6234 (Sept. 2, 1980) [45 FR 63682 (Sept. 25, 1980)]. Rule 3-14 Financial Statements are abbreviated because the rule requires that they exclude 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 federal and state income taxes. While Rule 3-14 does not require interim financial information, in practice registrants relying on Rule 3-14 also provide unaudited interim pre-acquisition income statements for the most recent year-to-date interim period because they are substantially required in most circumstances by Article 11 of Regulation S-X to provide pro forma information for the most recent year-to-date interim period. See Section II.D. below.

<sup>19</sup> Neither “significant property” nor “significant real estate operation” is defined in Regulation S-X.

<sup>20</sup> See Rule 3-14(a)(1). Only one year of Rule 3-14 Financial Statements is required if the real estate operation is not acquired from a related party, the registrant discloses the material factors considered in assessing the real estate operation, and the registrant indicates it is not aware of material factors that would cause the reported financial information not to be indicative of future operating results. If the registrant does not meet these conditions, three years of Rule 3-14 Financial Statements are required. A smaller reporting company is subject

Registrants required to file Rule 3-05 Financial Statements or Rule 3-14 Financial Statements are additionally required to file unaudited pro forma financial information as prescribed by Article 11 of Regulation S-X.<sup>21</sup> Pro forma financial information typically includes a pro forma balance sheet as of the end of the most recent period for which a consolidated balance sheet of the registrant is required and pro forma income statements for the registrant's most recent fiscal year and for the period from the most recent fiscal year end to the most recent interim date for which a balance sheet is required. The pro forma financial information is based on the historical financial statements of the registrant and the acquired or disposed business, and generally includes adjustments intended to show how the acquisition or disposition might have affected those financial statements had the transaction occurred at an earlier time.

Form 8-K generally requires registrants to file Rule 3-05 Financial Statements, Rule 3-14 Financial Statements, and related pro forma financial information within 75 days after consummation of the acquisition.<sup>22</sup> A similar 75-day filing period exists in registration statements and proxy statements for acquired or to be acquired businesses requiring Rule 3-05 Financial Statements, but not for acquired or to be acquired businesses requiring Rule 3-14

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to similar requirements under Rule 8-06 of Regulation S-X, but financial statements are only required for up to two fiscal years for acquisitions from related parties, instead of three years.

<sup>21</sup> See Rules 11-01 and 11-02. A smaller reporting company provides the pro forma financial information described in Rule 8-05 of Regulation S-X. Although the preliminary notes to Article 8 indicate that smaller reporting companies may wish to consider the enhanced guidelines in Article 11, smaller reporting companies are not required to comply with these items.

<sup>22</sup> Item 2.01 of Form 8-K requires that registrants make certain disclosures upon the acquisition or disposition of a significant amount of assets, including assets that constitute a business, within four business days of the consummation of the transaction. It does not require reporting for probable acquisitions or dispositions. Item 9.01 of Form 8-K provides that the required financial statements and pro forma financial information for the acquired business (including a real estate operation) may be filed not later than 71 calendar days after the initial report on Form 8-K is required to be filed, providing approximately 75 calendar days to file the acquired business financial statements and related pro forma financial information. A registrant may need to update the periods presented in Form 8-K in certain subsequently filed registration statements and proxy statements. *See* 17 CFR 210.3-12.

Financial Statements.<sup>23</sup>

In addition, certain registration statements<sup>24</sup> and proxy statements require audited financial statements and unaudited pro forma financial information for the substantial majority of individually insignificant consummated and probable acquisitions since the date of the most recent audited balance sheet if a significance test exceeds 50% for any combination of acquisitions subject to Rule 3-05.<sup>25</sup> Also, Rule 3-14 Financial Statements are required when the registrant has acquired or proposes to acquire a group of properties which in the aggregate are significant.<sup>26</sup>

## II. Discussion of Proposed Amendments

We are proposing changes to the requirements in Rule 3-05, Rule 3-14, and Article 11 of Regulation S-X and related rules and forms to improve the financial disclosure requirements about significant business acquisitions and dispositions.<sup>27</sup> The proposed amendments would generally:

- update the significance tests under these rules by:

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<sup>23</sup> Rule 3-05(b)(4) and Rule 11-01(c) provide that registration statements not subject to the provisions of 17 CFR 230.419 and proxy statements need not include separate financial statements of the acquired or to be acquired business and related pro forma financial information if the business does not exceed any of the conditions of significance in the definition of “significant subsidiary” in Rule 1-02(w) at the 50 % level, and either (A) the consummation of the acquisition has not yet occurred; or (B) the date of the final prospectus or prospectus supplement relating to an offering as filed with the Commission pursuant to 17 CFR 230.424(b) or the mailing date in the case of a proxy statement, is no more than 74 days after consummation of the business combination, and the financial statements have not previously been filed by the registrant. A similar provision applies to smaller reporting companies, but it is linked to the effective date of the registration statement instead of the date of the final prospectus or prospectus supplement. *See* Rule 8-04(c)(4).

<sup>24</sup> This additional requirement does not apply to all registration statements, such as registration statements filed on Form S-8 (17 CFR 239.16b).

<sup>25</sup> *See* Rule 3-05(b)(2)(i). Smaller reporting companies provide the same disclosure under Rule 8-04(c)(3).

<sup>26</sup> *See* Rule 3-14(a) and, for smaller reporting companies, Rule 8-06.

<sup>27</sup> As discussed in Section II.D.2., *infra*, Rule 11-01(a)(4) requires registrants to provide pro forma financial information upon the disposition or probable disposition of a significant portion of a business. Rule 11-01(b)(2) requires significance of a disposition to be determined by applying the definition of a significant subsidiary under Rule 1-02(w). Throughout this release, we discuss how the proposed amendments to the definition of significant subsidiary would impact disclosures for business dispositions.

- revising the Investment Test and the Income Test;
- expanding the use of pro forma financial information in measuring significance; and
- conforming the significance threshold and tests for a disposed business;
- require the financial statements of the acquired business to cover up to 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;
- clarify when financial statements and pro forma financial information are required and update the language used in our rules;
- permit the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board (“IFRS-IASB”) in certain circumstances;
- no longer require separate acquired business financial statements once the business has been included in the registrant’s post-acquisition financial statements for a complete fiscal year;
- modify and enhance the required disclosure for the aggregate effect of acquisitions for which financial statements are not required or are not yet required;
- align Rule 3-14 with Rule 3-05 where no unique industry considerations exist;
- clarify the application of Rule 3-14 regarding the determination of significance, the need for interim income statements, special provisions for blind pool offerings, and the scope of the rule’s requirements;
- amend the pro forma financial information requirements to improve the content and relevance of such information; and

- make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X.

In addition, we are proposing regulatory requirements specific to investment companies registered under the Investment Company Act and business development companies<sup>28</sup> (collectively, “investment companies”) to address the unique attributes of this group of registrants as discussed in more detail in Section II.E. below.

#### **A. Proposed Amendments to Generally Applicable Financial Statement Requirements for Acquired Businesses**

We are proposing amendments to the requirements in Rule 3-05 and related requirements in Rule 1-02(w), as described below.<sup>29</sup>

##### **1. Significance Tests**

We propose to revise the significance tests provided in Rule 1-02(w)<sup>30</sup> to improve their application and to assist registrants in making more meaningful significance determinations.

Specifically, we propose to revise the Investment Test and the Income Test.<sup>31</sup> Additionally, for

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<sup>28</sup> “Business development company” is defined in Section 2(a)(48) of the Investment Company Act, 15 U.S.C. 80a-2(a)(48).

<sup>29</sup> In addition to the proposed changes to the significance tests, we are proposing clarifying amendments to the definition of “significant subsidiary” to label the conditions as the Investment Test, the Asset Test, and the Income Test.

<sup>30</sup> The term “significant subsidiary” is also defined in Securities Act Rule 405, Exchange Act Rule 12b-2, and Investment Company Act Rule 8b-2. The Rule 405 and Rule 12b-2 definitions historically have been generally consistent with the Rule 1-02(w) definition. Accordingly, we are proposing to conform the definitions of significant subsidiary in Rule 405 and Rule 12b-2 to the proposed definition in Rule 1-02(w). However, as under the existing rules, the proposed amendments to Rule 1-02(w) that are only applicable to disclosure requirements under Regulation S-X, specifically proposed Rule 1-02(w)(1)(iii)(b)(3), would continue to be excluded from the proposed definitions in Rule 405 or Rule 12b-2. Unlike the other definitions, the definition in Rule 8b-2 has differed from the Rule 1-02(w) definition. We are proposing to conform the Rule 8b-2 definition of “significant subsidiary” to the proposed definition in Rule 1-02(w)(2) that is specifically tailored for investment companies. *See* Section II.E below.

<sup>31</sup> We are not proposing to substantively revise the Asset Test; however, we are proposing a number of non-substantive revisions to the significance tests generally, such as clarifying that the significance tests compare the “tested” subsidiary’s amounts to the registrant’s.



investment companies, we are proposing amendments to each of the Investment Test, Asset Test, and Income Test as described in Section II.E.1 below.

We note that, in addition to Rule 3-05, several of our other rules and forms require disclosure related to “significant subsidiaries” or otherwise rely on the significance tests in Rule 1-02(w) to determine the disclosure required.<sup>32</sup> We believe it is appropriate to apply consistent significance tests for each of these purposes. The proposed amendments are intended to reflect more accurately the relative significance to the registrant of the acquired business and to reduce anomalous results in the application of the definition of “significant subsidiary.” In addition, maintaining the historical conformity between the “significant subsidiary” definitions would avoid unnecessary regulatory complexity through consistent application of significance determinations made at the acquisition date and those made post-acquisition when the acquired business is a subsidiary of the registrant.

#### **a. Investment Test**

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<sup>32</sup> See, e.g., 17 CFR 210.9-03, which requires bank holding companies and banks to reflect on their balance sheets certain loans and indebtedness of their significant subsidiaries as defined in Rule 1-02(w); 17 CFR 210.3-09, 17 CFR 210.4-08(g), and Item 17(c)(2) of 17 CFR 249.220f (“Form 20-F”), which rely on the significance tests in Rule 1-02(w) to determine the financial statements and summarized financial information required for the registrant’s equity method investees; 17 CFR 229.601(b)(21) and Instruction 8 as to Exhibits of Form 20-F, which both rely on Rule 1-02(w) to determine the subsidiaries that must be included in the list of subsidiaries required as an exhibit; Item 17(b)(6)(3) of Form F-4, which relies on the significance tests in Rule 1-02(w) to determine the financial statements required for foreign companies being acquired that do not meet the requirements to use 17 CFR 239.34 (“Form F-3”); Item 4.C of Form 20-F, which requires a detailed list of the registrant’s significant subsidiaries; 17 CFR 229.304(a)(1) and (2), Item 9(d) of 17 CFR 240.14a-101 (“Schedule 14A”), Item 4.01 of Form 8-K, Item 4 of 17 CFR 239.93 (“Form 1-U”), and Item 16F of Form 20-F, which require disclosure about changes in the auditors of the registrant (or issuer, as applicable) or its significant subsidiaries; Item 3 of 17 CFR 249.308a (“Form 10-Q”) and Item 13 of Form 20-F, which require disclosure about defaults of the registrant and its significant subsidiaries and material arrearages/delinquencies in the payment of dividends on preferred stock of the registrant or any of its significant subsidiaries; 17 CFR 229.101(a)(1), which requires certain disclosures, such as year and form of organization, bankruptcy, and others, for the registrant and any of its significant subsidiaries; 17 CFR 229.103, which requires disclosure of certain legal proceedings, including bankruptcy and similar proceedings, for the registrant and any of its significant subsidiaries; and Item 4.A.4 of Form 20-F, which requires general disclosure about the development of and structural changes in the business of the registrant and its significant subsidiaries. See also Rule 11-01(b) and Proposed Rule 11-01(b).

Currently, the Investment Test compares the registrant's investment in and advances to the acquired business to the carrying value of the registrant's total assets. We propose to revise the Investment Test to 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"), when available.<sup>33</sup> If the registrant does not have an aggregate worldwide market value, we propose to retain the existing test.

We believe that using the registrant's aggregate worldwide market value would align the Investment Test more closely with the economic significance of the acquisition to the registrant. While the purchase price for a recent or probable acquisition is generally consistent with the fair value of the underlying business, the measure against which the purchase price is compared under the current test (i.e., total assets) may not fully reflect the registrant's current fair value.<sup>34</sup> In response to the 2015 Request for Comment, commenters supported revising the Investment Test to use a measure of the registrant's fair value instead of its total assets.<sup>35</sup> While commenters recommended various methods of determining fair value, we are proposing aggregate worldwide market value because it is readily available and objectively determined by the market.

In order to further improve the Investment Test, we propose to address when the

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<sup>33</sup> The value under the proposed rule differs from the value currently used by registrants to determine accelerated filer status under Rule 12b-2 because it includes the value of common equity held by affiliates and it is determined as of the last business day of the registrant's most recently completed fiscal year. By contrast, Rule 12b-2 looks to the value of common equity held by non-affiliates and is determined as of the last business day of the registrant's most recently completed second fiscal quarter. *See* Rule 12b-2.

<sup>34</sup> For example, the Investment Test uses the carrying value of a registrant's total assets as of the most recent balance sheet date, which represents a combination of fair value for certain assets (e.g., financial instruments) and historical cost for other assets (e.g., property, plant and equipment and intangible assets). The test further excludes the value of certain assets not permitted to be recognized (e.g., certain internally developed intangible assets) and is not reduced by the value of liabilities.

<sup>35</sup> *See, e.g.,* letters from the American Bar Association (Nov. 14, 2014) ("ABA"), BDO USA, LLP (Dec. 7, 2015) ("BDO"), Center for Audit Quality (Nov. 25, 2015) ("CAQ"), CFA Institute (Mar. 2, 2016) ("CFA"), Davis Polk & Wardwell LLP (Nov. 30, 2015) ("Davis Polk"), Polk, Deloitte & Touche LLP (Nov. 23, 2015) ("DT"), Ernst & Young LLP (Nov. 20, 2015) ("EY"), Grant Thornton LLP (Dec. 1, 2015) ("Grant"), KPMG LLP (Nov. 30, 2015) ("KPMG"), and PricewaterhouseCoopers LLP (Nov. 30, 2015) ("PwC").

registrant's aggregate worldwide market value shall be determined,<sup>36</sup> provide further instructions on a registrant's "investments in" the tested subsidiary<sup>37</sup> for acquisitions and dispositions,<sup>38</sup> and clarify the applicability of the test to combinations between entities under common control.<sup>39</sup> These proposed amendments would address certain practical questions<sup>40</sup> that

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<sup>36</sup> We propose Paragraph (w)(1)(i)(A) to provide that aggregate worldwide market value of the registrant's voting and non-voting common equity shall be determined as of the last business day of the registrant's most recently completed fiscal year, which for acquisitions and dispositions shall be at or prior to the date of acquisition or disposition.

<sup>37</sup> Rule 1-02(w) defines the term "significant subsidiary." Rules 3-05 and 3-14 use the conditions in Rule 1-02(w) when establishing the test for registrants to determine whether financial statements are required for businesses acquired or to be acquired. While we recognize that acquired businesses are often not subsidiaries, we use the term "tested subsidiary" throughout this release, rather than "tested business" or another term, to avoid confusion when using the conditions in Rule 1-02(w) in connection with the determination in Rule 3-05 and Rule 3-14.

<sup>38</sup> We propose Paragraph (w)(1)(i)(C) to require that the "investment in" the tested subsidiary in an acquisition include the fair value of contingent consideration required to be recognized at fair value by the registrant at the acquisition date under U.S. GAAP or IFRS-IASB, as applicable. If recognition at fair value is not required, the proposed amendment would require all contingent consideration to be included, except sales-based milestones and royalties, unless the likelihood of payment is remote. The "investment in" the tested subsidiary also would exclude the registrant's proportionate interest in the carrying value of assets transferred by the registrant to the tested subsidiary that will remain with the combined entity after the acquisition because we believe this would provide a more accurate measure of the tested subsidiary's relative significance. We believe our proposal is consistent with FASB standard setting for business combinations that clarified that for acquisition accounting the consideration transferred should exclude such amounts. *See* FASB ASC 805-30-30-8. For similar reasons, we also propose providing in Paragraph (w)(1)(i)(D) that the "investment in" the tested subsidiary in a disposition equal the fair value of the consideration, which would include contingent consideration, for the disposed subsidiary when comparing it to the registrant's aggregate worldwide market value or the carrying value of the disposed subsidiary when comparing it to the registrant's total assets.

<sup>39</sup> Rule 1-02(w)(1) provides that for a proposed combination between entities under common control, when the number of common shares exchanged or to be exchanged exceeds 10% of the registrant's common shares outstanding at the date the combination is initiated, the Investment Test for significance is met. We are proposing Rule 1-02(w)(1)(i)(B) to similarly provide that the Investment Test would be met when either net book value of the tested subsidiary exceeds 10% of the registrants' and its subsidiaries consolidated total assets or the number of common shares exchanged or to be exchanged by the registrant exceeds 10% of its total common shares outstanding at the date the combination is initiated. The addition of net book value to the test as proposed recognizes that such combinations may be effected by transferring net assets, rather than exchanging shares, and that the resulting accounting by the registrant typically recognizes the combination using the parent's historical carrying value of the transferred entity or business. *See, e.g.,* FASB ASC 805-50. We also propose to add a reference to "businesses" in Rule 1-02(w) such that the resulting phrasing is "combinations between entities or businesses under common control" for circumstances where the significant subsidiary definition is referenced by rules establishing requirements for acquired businesses.

<sup>40</sup> Commission staff has provided informal guidance to address practical questions. For example, *see* U.S. Sec. & Exch. Comm'n., Division of Corporation Finance's Financial Reporting Manual, available at <https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf> (last updated Dec. 1, 2017) ("FRM"). The FRM sets forth the informal guidance of the staff in the Division of Corporation Finance related to various financial reporting matters. The FRM is not a rule, regulation, or statement of the Commission.

may arise when applying the proposed Investment Test and should therefore simplify compliance by registrants.<sup>41</sup>

**b. Income Test**

Currently, the Income Test focuses on a single component, net income,<sup>42</sup> which can include infrequent expenses, gains or losses that can distort the determination of relative significance. For registrants with marginal or break-even net income or loss in a recent fiscal year, the use of a net income component by itself can also have the effect of requiring financial statements for acquisitions that otherwise would not be considered material to investors. In these circumstances comparatively small entities may trigger the requirement for Rule 3-05 Financial Statements, which can be costly to prepare. Commission staff regularly receives and grants under delegated authority requests for relief in these circumstances where the disclosure of these acquisitions would not be material to investors.<sup>43</sup> A number of commenters expressed concern with the existing Income Test, with many of these commenters recommending replacing or

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<sup>41</sup> See FRM, *supra* note 40, at Sections 2015.5 “*Investment Test – Acquisition Accounting*” and 2015.7 “*Investment Test – Reorganization of Entities Under Common Control*.”

<sup>42</sup> Specifically, the current Income Test uses income from continuing operations before income taxes. Prior to 1981, the “significant subsidiary” definition included a revenue test. The Commission eliminated the revenue test in favor of the net income test noting in part that “...the presentation of additional financial disclosures of an affiliated entity may not be meaningful if the affiliate has a high sales volume but a relatively low profit margin” and observing that in such circumstances, the affiliate has little financial effect on the operating results of the consolidated group. See *Separate Financial Statements Required by Regulation S-X*, Rels. No. 33-6359 (Nov. 6, 1981)[46 FR 56171 (Nov. 16, 1981)]. For these reasons, we believe it is important to retain a net income component as part of the Income Test rather than rely exclusively on a revenue component.

<sup>43</sup> Pursuant to 17 CFR 210.3-13 (“Rule 3-13”) of Regulation S-X, the Commission may, upon the request of the registrant, and where consistent with the protection of investors, permit the omission of one or more required financial statements or the filing in substitution therefor of appropriate statements of comparable character. The Commission has delegated authority to the staff in the Division of Corporation Finance to grant requests for relief under Rule 3-13.

supplementing the net income test with a revenue component.<sup>44</sup>

We propose to revise the Income Test by adding a new revenue component<sup>45</sup> and to simplify the calculation of the net income component by using income or loss from continuing operations *after* income taxes. We expect adding a revenue component would reduce the anomalous results that may occur by relying solely on net income.<sup>46</sup> We believe that this change, along with simplifying these calculations, would reduce complexity and preparation costs without sacrificing material information that investors may need to evaluate these transactions.

Under the proposed amendments, the Income Test would require that, where the registrant and its subsidiaries consolidated and the tested subsidiary have recurring annual revenue, the tested subsidiary must meet both the new revenue component and the net income component. In this case, the registrant would use the lower of the revenue component and the net income component to determine the number of periods for which Rule 3-05 Financial

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<sup>44</sup> See, e.g., letters from ABA, CAQ, U.S. Chamber of Commerce (Nov. 30, 2015), Davis Polk, EY, and PWC. Two commenters specifically recommended supplementing the Income Test with a revenue component. See letters from CFA and KPMG.

<sup>45</sup> The proposed revenue component would compare the registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenues (after intercompany elimination) to such consolidated total revenues for the registrant's most recently completed fiscal year.

<sup>46</sup> We believe that revenue is an important indicator of the operations of a business and generally has less variability than net income. For example, expenses related to historical capitalization (e.g., interest expense) as well as infrequent expenses, such as those for litigation or impairment, can affect net income and the existing Income Test. That impact may be to either deem as insignificant an acquired business that is expected to have material future impact on the registrant or deem as significant an acquired business that is not expected to have a material future impact on the registrant. The potential for these effects suggests that the Income Test should be revised to include an income statement metric that is less subject to such effects. Because not all registrants report metrics such as "profit margin" and "operating income," and these metrics could also have similar potential variability, we believe "revenue" is a more appropriate indicator. Consistent with the Commission's past observations about a revenue test that is not linked to net income (*see supra* note 42), we propose to retain net income and add a revenue component when both the registrant and tested subsidiary have recurring annual revenues.

Statements are required.<sup>47</sup> Where a registrant or tested subsidiary does not have recurring annual revenues, the revenue component is less likely to produce a meaningful assessment and therefore only the net income component would apply. To reduce anomalous results in these circumstances, we also propose revising the Income Test to use the average of the absolute value of net income when the existing 10% threshold in Computational Note 2 to Rule 1-02(w)<sup>48</sup> is met and the proposed revenue component of the Income Test does not apply.

By revising the Income Test to require that the registrant exceed both revenue and net income components when the registrant and the tested subsidiary have recurring annual revenue, we believe the test would more accurately determine whether a business is significant to the registrant and would reduce the frequency of the anomalous result of immaterial acquisitions being deemed significant.

We also propose to revise the net income component calculation so that it is based on income or loss from continuing operations *after* income taxes. Income tax is a recurring and often material line item. Further, the current calculation, which is based on income from continuing operations *before* income taxes, may require additional calculations for components of net income that are presented on a post-tax basis<sup>49</sup> with the result that a registrant may not be able to use amounts directly from the financial statements. Instead, the proposed amendments refer to income or loss from continuing operations after income taxes, which would permit a

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<sup>47</sup> See proposed Rule 3-05(b)(2) of Regulation S-X.

<sup>48</sup> See Computational Note 2 to Rule 1-02(w) of Regulation S-X. Average income should be substituted for purposes of the computation if income of the registrant and its subsidiaries consolidated exclusive of amounts attributable to any noncontrolling interests for the most recent fiscal year is at least 10% lower than the average of the income for the last five fiscal years. See proposed Rule 1-02(w)(1)(iii)(B)(2).

<sup>49</sup> See, e.g., 17 CFR 210.5-03(b)12 (“Rule 5-03(b)12”). Rule 5-03(b)12, *Equity in Earnings of Unconsolidated Subsidiaries and 50 Percent or Less Owned Persons*, provides for a component of net income from continuing operations to be presented net of tax.

registrant to use line item disclosure from its financial statements, simplifying the determination.

We are also proposing to clarify the net income component by inserting a reference to the *absolute value* of equity in the tested subsidiary’s consolidated income or loss from continuing operations, which we believe will mitigate the potential for misinterpretation that may result from inclusion of a negative amount in the computation.<sup>50</sup> We propose to calculate net income and average net income using absolute values. For net income, we believe this would serve to clarify that the test applies when a net loss exists, and is to be used when either the tested subsidiary or the registrant, but not both, has a net loss. For average income, our proposal differs from current staff interpretation, which indicates that “zero” should be used for loss years in computing the average.<sup>51</sup> We believe calculating average net income using the absolute value of the loss or income amounts for each year and then calculating the average would make the average income test more indicative of relative significance.

In addition, proposed Rules 3-05(b)(3) and 11-01(b)(3) will also clarify that the Income Test may be determined using the acquired business’s revenues less the expenses permitted to be omitted by proposed Rules 3-05(e) and 3-05(f) if the business meets the conditions in those proposed rules.<sup>52</sup> Finally, we are proposing additional non-substantive amendments to the net income component that we believe will simplify the description and application of the test.<sup>53</sup>

## **Request for Comment**

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<sup>50</sup> See proposed Rule 1-02(w)(1)(iii)(B)(2).

<sup>51</sup> See FRM, *supra* note 40, at Section 2015.8.

<sup>52</sup> See discussion relating to Rule 3-05(e) in Section II.A.3 and Rule 3-05(f) in Section II.A.4. below.

<sup>53</sup> Specifically, we are proposing to replace the phrase “exclusive of amounts attributable to any noncontrolling interests” in the net income component with the phrase “attributable to the controlling interests.” We are also proposing to revise Rule 1-02(w) to remove the Computational Note designation but retain the substance of the notes in the rule and make conforming amendments consistent with the proposed amendments to the revised Income Test. Additionally, Paragraph (w)(1)(iii)(B)(3) would clarify that the rule is not intended to modify the existing Rule 3-05(a)(3) requirement that acquisitions of a group of related businesses shall be treated as if they are a single acquisition. Finally, we are incorporating the Note to Paragraph (w) into Paragraph (w).

1. We are proposing to revise the significance tests to improve their application and assist registrants in making more meaningful significance determinations. Are the proposed revisions appropriate? Are there additional revisions we should consider to further improve the significance tests?
2. We are proposing to revise the Investment Test to use aggregate worldwide market value to reflect the size of the acquirer while retaining investment in and advances to the acquired business to reflect the size of the acquired business. Are these measures sufficiently comparable? Are there particular types of transactions for which these measures would lead to a less-informative indicator of significance? Does our proposed use of aggregate worldwide market value in the Investment Test more closely reflect the relative significance of the acquisition to the registrant? Is there a better proxy that we could use for fair value in the Investment Test? For example, would aggregate worldwide market value of the registrant's voting and non-voting common equity held by its non-affiliates, a value based on the expected offering price in an initial public offering, enterprise value, or some other market valuation be a more appropriate proxy? Why or why not?
3. We have proposed to require that the "investment in" the tested subsidiary in an acquisition include the fair value of contingent consideration required to be recognized at fair value by the registrant at the acquisition date under U.S. GAAP or IFRS-IASB, as applicable. If recognition at fair value is not required, the proposed amendment would require all contingent consideration to be included, except sales-based milestones and royalties, unless the likelihood of payment is remote. Generally, would the inclusion of contingent consideration provide a more accurate determination of significance? Why or



why not? Are there practical impediments to our proposed approach to the inclusion of contingent consideration? If so, what are they and how would they best be mitigated? For example, should we require the gross amount of contingent consideration, rather than its fair value, be used in significance determinations regardless of the accounting the registrant is required to apply at the acquisition date? Why or why not? If contingent consideration is not required to be recognized at fair value, would inclusion of contingent consideration unless the likelihood of payment is remote provide a more accurate determination of significance? In this circumstance, is the exclusion of sales-based milestones and royalties an appropriate practical expedient to the determination of significance? Alternatively, should we require registrants to estimate these amounts in order to determine significance? Why or why not? Does the phrase “sales-based milestones or royalties” capture consideration that is contingent on sales or should it be further refined or defined?

4. For dispositions, would the use of the fair value of consideration, which would include contingent consideration, provide a more accurate determination of significance than the gross amount of consideration when comparing to the aggregate worldwide market value of the registrant? Why or why not? Are there practical impediments to our proposed approach to the inclusion of contingent consideration? If so, what are they and how would they best be mitigated? Should we exclude contingent consideration from the determination of the significance of a disposed business when comparing to the aggregate worldwide market value of the registrant? Why or why not? Should we exclude from the determination of significance contingent consideration in the form of sale-based milestones or royalties when comparing to the aggregate worldwide market value of the

registrant? Why or why not? When the registrant has no such aggregate worldwide market value, will comparing the carrying value of the disposed subsidiary to total assets of the registrant appropriately reflect the relative significance of the disposed business to the registrant? Why or why not?

5. We have proposed to add a revenue component to the Income Test. Would this approach more accurately reflect the significance of the acquisition or could it result in material acquisitions not triggering financial statement disclosures? Would it reduce incidents of otherwise insignificant acquisitions being deemed significant by registrants that have marginal or break-even net income?
6. Would using different percentage thresholds for the revenue component and the income component mitigate the potential that the proposed Income Test would under-identify transactions? Why or why not? For example, would the proposed Income Test be a better indicator of relative significance if the revenue component used a lower percentage threshold, for example 15% or 10%, than that used for the income component? Why or why not? If the revenue component and income component were to have different percentage thresholds, what should those percentages be? Are there other ways to modify the Income Test that would better address this issue?
7. Will our proposal to require recurring annual revenue appropriately limit the circumstances when the revenue component would not provide a meaningful result? Should we instead provide that the revenue component would not apply if either the registrant or tested subsidiary had no or nominal revenue? Why or why not? If so, should we define nominal revenue and what definition should we propose?

8. We are proposing that registrants use the lower of the total revenue or the net income components of the proposed Income Test to determine the number of years of required audited financial statements. Would the use of the lower of the two components provide an appropriate number of periods of pre-acquisition financial statements when an acquired business is significant? If not, why not? Is there a more appropriate way to determine the number of periods that should be presented if the Income Test is met? If yes, why would this alternative approach be more appropriate?
9. Would the Income Test better determine relative significance if we eliminated the net income component entirely and relied solely on the proposed revenue component? Why or why not?
10. Would the Income Test better determine relative significance if we required using the proposed revenue component in place of the proposed income component only when the acquirer's income or loss is small? Why or why not? If we required use of the revenue component only when the acquirer's income or loss is small, how should we define when this switch from the income component to the revenue component must occur? For example, should we require use of the revenue component when the absolute value of the acquirer's return on assets was less than 1%? Why or why not? Would a "less than 1%" standard be appropriate or would a different percentage be a more appropriate standard? If we required the switch to be made based on the acquirer's return on assets, how could we mitigate the inconsistent results that might occur across industries depending on the extent of an acquirer's reliance on human capital versus material capital? For acquirers that have large asset bases, would a return on asset approach be subsumed by the existing Asset Test?

11. Would the Income Test be improved by using a different income statement-metric test like gross profit (loss) or operating income (loss) in place of our proposed revenue component? Why or why not? If we eliminated the net income component and replaced it with a gross profit (loss) or operating income (loss) test, how would it apply to tested subsidiaries and registrants that do not report gross profit (loss) or operating income (loss)?
12. We are proposing to simplify the net income component of the Income Test by using after-tax net income and absolute values. Would the proposed revision to use after tax net income and absolute values simplify the determination while still accurately identifying significance? Why or why not? Should we retain use of pre-tax net income? Why or why not?
13. Under our proposal, average income must be used to calculate the income component of the Income Test if the registrant or the tested subsidiary does not have recurring annual revenue and the absolute value of the registrant's income or loss from continuing operations attributable to the controlling interests for the most recent fiscal year is at least 10% lower than the average of the absolute value of such amounts for the registrant for each of its last five fiscal years.
- Would it be appropriate to require income averaging where the 10% threshold is met and registrants are able to rely on the revenue component? Are there modifications that we should consider to the average income computation? Are there other circumstances where the determination would be more accurate by removing the revenue component or applying income averaging?

- If the 10% threshold is retained, calculating the average using absolute values may increase the frequency with which the average must be used. Does calculating average income using the absolute value of losses rather than the current practice of assigning a value of zero to those years result in a better indicator of relative significance? Why or why not? Would modifying the existing 10% threshold in Computational Note 2 to Rule 1-02(w) in lieu of our proposal to use absolute values better reflect when an average should be used? If so, what percentage should we use and why? Are there other ways to modify the calculation of average income to be a better indicator of relative significance in the circumstances to which we propose to apply it?

14. Are there other revisions to the Investment Test, Income Test or Asset Test that we should consider?

15. Are there other tests that would be a more appropriate indicator of relative significance? For example, should we add a test based on cash flows from operating, investing or financing activities? Why or why not?

16. The term “significant subsidiary” is defined in Rule 1-02(w) and also in Securities Act Rule 405 and Exchange Act Rule 12b-2. These definitions historically have been generally consistent with the exception of current Computational Note 3 relating to the aggregation of combined entities, which is generally not relevant for purposes of Rule 405 or 12b-2. Is it appropriate to consistently apply the definition of significant subsidiary across these rules while continuing to exclude the language relating to aggregation of combined entities? Would these rules be better implemented if the definitions further diverged? If so, how?

17. Is it clear that “significant subsidiary” determinations should be made using amounts derived from consolidated financial statements of the tested subsidiary and consolidated financial statements of the registrant? Should we revise our rules to more explicitly state that?
18. Should we revise the “significant subsidiary” determination to deem a subsidiary as significant if it is material to the registrant rather than using specific percentage conditions? Why or why not? If we should revise the determination to use a materiality standard, how should that standard be applied? Would a materiality standard yield consistent determinations between registrants? How would a materiality standard impact the disclosure provided and a registrant’s ability to timely access capital?

## **2. Audited Financial Statements for Significant Acquisitions**

As noted above, Rule 3-05 Financial Statements may be required for up to three years depending on the relative significance of the acquired or to be acquired business. We propose to revise Rule 3-05 to require up to two years depending on the relative significance. Unlike the historical financial statements of the registrant upon which investors rely to make investment decisions about the registrant, the Rule 3-05 Financial Statements are used, along with pro forma financial information, to discern how the acquired business may affect the registrant. We believe two years of pre-acquisition financial statements, would be sufficient to allow investors to understand the possible effects of the acquired business on the registrant. Relatedly, we are also proposing to require the inclusion of certain forward-looking information in pro forma financial information.<sup>54</sup>

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<sup>54</sup> See the discussion in Section II.D.1. below.

We note that older financial statements, such as the third year of Rule 3-05 Financial Statements, can be less relevant for evaluating an acquisition because, due to their age, they are less likely to be indicative of the current financial condition, changes in financial condition and results of operations of the acquired business.<sup>55</sup> Pre-acquisition financial statements can also have less utility because they do not reflect the changes in the acquired business or combined entity that occur post-acquisition or the accounting required by the registrant's comprehensive basis of accounting. Moreover, regardless of the number of years presented, if trends depicted in Rule 3-05 Financial Statements are not indicative or are otherwise incomplete, 17 CFR 210.4-01(a) ("Rule 4-01(a)") requires that a registrant 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." Further, the requirement to prepare and obtain an audit of the third year of pre-acquisition financial statements can add significant incremental cost and time to the preparation of required disclosure, which is further exacerbated if a change in the acquired business's management or independent auditor has occurred, and may delay a registrant's time to market and access to capital.

Accordingly, we propose eliminating the requirement to file the third year of Rule 3-05 Financial Statements for an acquisition that exceeds 50% significance.<sup>56</sup> In response to the 2015 Request for Comment, several commenters recommended eliminating the requirement to provide

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<sup>55</sup> In some circumstances, Rule 3-05 Financial Statements can depict a year beginning more than four years before consummation of the acquisition. For example, the third year of Rule 3-05 Financial Statements for a calendar year-end business acquired on February 27, 2018 would be 2014. If the business were acquired at a later date in 2018, the third year of Rule 3-05 Financial Statements would be 2015.

<sup>56</sup> See proposed Rule 3-05(b)(2).

three years of Rule 3-05 Financial Statements,<sup>57</sup> while only one recommended retaining the current periods.<sup>58</sup>

We also propose to revise Rule 3-05 for acquisitions where a significance test exceeds 20%, but none exceeds 40%, to require financial statements for the “most recent” interim period specified in Rule 3-01 and 3-02 rather than “any” interim period. This proposed revision would eliminate the need to provide a comparative interim period when only one year of audited Rule 3-05 Financial Statements is required. Providing a comparative interim period when there is no requirement for a corresponding comparative annual period may have limited utility for investors and creates an additional burden on registrants to prepare such information. Moreover, we believe that focusing on the most recent interim period would provide the most relevant and material information to investors.

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19. Is our proposal to eliminate the third year of pre-acquisition audited financial statements required for business acquisitions exceeding 50% significance in Rule 3-05(b)(2)(iv) appropriate? Why or why not? Are there other changes that we should consider that would reduce compliance burdens for issuers but continue to provide the material information investors need to make informed investment decisions?

20. Is our proposal to eliminate the comparative interim period when only one year of audited Rule 3-05 Financial Statements is required appropriate? Why or why not? Are there other changes that we should consider?

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<sup>57</sup> See letters from BDO, CAQ, Crowe Horwath LLP (Nov. 30, 2015) (“Crowe”), DT, Edison Electric Institute and American Gas Association (Nov. 30, 2015) (“EEI/AGA”), EY, Grant, KPMG, and RSM US LLP (Nov. 30, 2015) (“RSM”).

<sup>58</sup> See letter from California Public Employees’ Retirement System (Nov. 30, 2015) (“CalPERS”).



### 3. Financial Statements for Net Assets that Constitute a Business

Registrants frequently acquire a component of an entity, such as a product line or a line of business contained in more than one subsidiary of the selling entity, that is a business as defined in Rule 11-01(d) but does not constitute a separate entity, subsidiary, or division. These businesses may not have separate financial statements or maintain separate and distinct accounts necessary to prepare Rule 3-05 Financial Statements because they often represent only a small portion of the selling entity. In these circumstances, making relevant allocations of the selling entity's corporate overhead, interest, and income tax expenses necessary to provide Rule 3-05 Financial Statements for the business may be impracticable.

We propose to permit<sup>59</sup> registrants to provide audited financial statements of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses)<sup>60</sup> if:

- the 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;

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<sup>59</sup> See proposed Rule 3-05(e). Our proposal is generally consistent with Commission staff's exercise of delegated authority pursuant to Rule 3-13 of Regulation S-X in these circumstances. See also FRM, *supra* note 40, at Section 2065 "Acquisition of Selected Parts of an Entity may Result in Less than Full Financial Statements."

<sup>60</sup> The proposed rule clarifies that federal and state income tax may be excluded.

- 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, specifically: the type of omitted expenses and the reasons why they are excluded from the financial statements; information about the business's operating, investing, and financing cash flows, to the extent available; an explanation of the impracticability of preparing financial statements that include the omitted expenses; and a description of how the financial statements presented are not indicative of the financial condition or results of operations of the acquired business going forward because of the omitted expenses.

Recognizing the difficulty registrants face in obtaining and the cost of preparing financial statements that include the expenses proposed to be omitted, we believe permitting registrants to provide abbreviated financial statements as proposed, while requiring the proposed additional disclosures, appropriately balances the cost of preparing financial disclosure with the protection of investors. In response to the 2015 Request for Comment, commenters generally supported permitting the use of abbreviated financial statements without first seeking relief from the Commission.<sup>61</sup>

### **Request for Comment**

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<sup>61</sup> See, e.g., letters from ABA-Committees, BDO, CAQ, Cyprus Energy Partners, L.P. (Nov. 30, 2015), DT, EEI/AGA, EY, Grant, KPMG, and RSM.

21. Are the proposed conditions for permitting registrants to provide abbreviated financial statements appropriate? Are there other conditions that should be applied or other disclosures that should be required? Are any of the conditions unnecessary or counterproductive?
22. Acquired product lines typically meet the definition of a business, but can have minimal historical balance sheet information associated with them, such as the carrying value of acquired inventory. Similarly, income statement information beyond revenue and costs of sales may have limited utility when the selling effort relates to a larger product portfolio that includes the acquired product line, rather than the acquired product line itself, and when historical research and development expense is not specific to the acquired product line. In these and similar circumstances, should we permit registrants to provide other information, such as revenue and cost of revenues, in lieu of abbreviated financial statements? Why or why not? Should we require the other information to be audited? Why or why not? Is it practicable to audit the other information? Why or why not? If the other information is unaudited, how would that affect investors and other market participants that use the information? If we should permit other information, what conditions best identify and limit the circumstances when it would be appropriate to permit the other information? If we permit other information, should the 75-day filing period specified in Rule 3-05 for registration statements and proxy statements and in Item 9.01 of Form 8-K apply? Should Article 11 of Regulation S-X pro forma financial information be required?
23. As proposed, statements of revenues and expenses must include selling, distribution, marketing, general and administrative, and research and development expenses incurred

to generate the revenue reflected in the statements. Does the proposed requirement provide sufficient clarity regarding the expenses that must be included? Does the proposed requirement provide sufficient clarity regarding the expenses that may be omitted? Why or why not? If not, how can we better make these distinctions?

#### **4. Financial Statements of a Business that includes Oil and Gas Producing Activities**

Rule 3-05 applies to acquisitions of a significant business<sup>62</sup> that includes oil and gas producing activities.<sup>63</sup> However, Rule 3-05 does not specify industry-specific disclosures that may be useful to understand such activities. In the absence of specific requirements, registrants generally provide certain industry-specific disclosures specified in FASB ASC Topic 932 *Extractive Activities – Oil and Gas* (“ASC 932 Disclosures”)<sup>64</sup> on an unaudited basis for each full year of operations presented for the acquired business.

Rule 3-05 also does not specify the form and content of Rule 3-05 Financial Statements when the acquired business generates substantially all of its revenues from oil and gas producing activities. Often, this type of business represents a component of an entity that does not constitute a separate entity, subsidiary, segment, or division for which separate financial statements exist and for which historical depreciation, depletion, and amortization expense is likely not meaningful to an understanding of the potential effects of the acquired business on the

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<sup>62</sup> See Rule 11-01(d).

<sup>63</sup> See the definition of “oil and gas producing activities” at § 210.4-10(a)(16).

<sup>64</sup> See FASB ASC Topic 932 *Extractive Activities – Oil and Gas*, 932-235-50-3 through 50-11 and 932-235-50-29 through 50-36, and FRM, *supra* note 40, at Section 2065.12. These supplemental disclosures are required in the financial statements of publicly traded companies with significant oil- and gas- producing activities and provide additional context for those financial statements.

registrant.<sup>65</sup> In these circumstances and when certain additional criteria are met, pursuant to Rule 3-13 and delegated authority, Commission staff has permitted registrants to provide abbreviated financial statements that consist of income statements modified to exclude expenses not comparable to future operations.<sup>66</sup>

Proposed Rule 3-05(f) would codify these reporting practices. Specifically, for a significant acquired business that includes *significant oil- and gas-producing activities* (as defined in the FASB ASC Master Glossary), we propose that Rule 3-05 Financial Statements include the ASC 932 Disclosures on an unaudited basis for each full year of operations presented for the acquired business.<sup>67</sup> Additionally, we propose that the Rule 3-05 Financial Statements may be audited statements of revenues and expenses that exclude depletion, depreciation, and amortization expense, corporate overhead expense, income taxes, and interest expense that are not comparable to the proposed future operations if: (1) substantially all of the revenues of the business are generated from oil and gas producing activities,<sup>68</sup> and (2) the conditions of proposed Rule 3-05(e)(1) through (4) and (e)(6) are met.<sup>69</sup> We believe these conditions would appropriately balance the cost of preparing the disclosure with the protection of investors. We also believe codifying these practices would provide clarity for registrants regarding the

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<sup>65</sup> Historical depreciation, depletion, and amortization expense is frequently not maintained at the property level and does not reflect the acquiring company's basis in the properties.

<sup>66</sup> See FRM, *supra* note 40, at Section 2065.6, 2065.11, and 2065.12. Permitting registrants in these circumstances to substitute abbreviated income statements that omit expenses not comparable to future operations is consistent with the financial statement requirements specified in Rule 3-14 for acquired real estate operations. Rule 3-14 specifies that Rule 3-14 Financial Statements must omit depreciation expenses not comparable to future operations.

<sup>67</sup> See ASC 932-235-50-3 through 50-11 and 932-235-50-29 through 50-36, which may be presented as unaudited supplemental information. We are proposing this definition of *significant oil- and gas-producing activities* to be consistent with current practice whereby the FASB's significance threshold is applied in determining whether to present the ASC 932 Disclosures in Rule 3-05 Financial Statements, even if the acquired business is not a publicly-traded company.

<sup>68</sup> Under our proposal, "oil and gas producing activities" would be defined by reference to § 210.4-10(a)(16).

<sup>69</sup> See discussion in Section II.A.3 above.

application of Commission rules in these circumstances and could facilitate compliance to the benefit of both registrants and investors.

### **Request for Comment**

24. Are the proposed conditions for permitting businesses that have oil and gas producing activities to provide abbreviated financial statements and requiring them to provide industry-specific supplemental information appropriate? Are there other conditions that should be applied or other disclosures that should be required?

## **5. Timing and Terminology of Financial Statement Requirements**

We propose revising Rule 3-05 and Article 11 to clarify when financial statements<sup>70</sup> and pro forma financial information are required, and to update the language to take into account concepts that have developed since adoption of the rules over 30 years ago.<sup>71</sup> Specifically, the 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 by 17 CFR 210.3-01 of Regulation S-X (“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.<sup>72</sup> We also propose to clarify that Rule 3-05 applies when the fair value option is

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<sup>70</sup> We additionally propose to clarify that “financial statements” need not include related schedules specified in Article 12 (17 CFR 210.12). Item 9.01(a)(2) of Form 8-K already provides that supporting schedules of financial statements need not be filed in these circumstances. The staff further applies this approach to acquired business financial statements required in registration statements and proxy statements. *See* FRM, *supra* note 40, at Section 2005.2.

<sup>71</sup> In addition we are proposing changes to Rule 8-05 for smaller reporting companies to conform with the proposed changes to Article 11.

<sup>72</sup> As discussed in Section II.B.1 below, we are proposing to no longer require Rule 3-05 Financial Statements in Securities Act registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements for a complete fiscal year. In conjunction with that proposal, we are proposing conforming amendments to Rule 3-05(a)(1) to clarify when financial statements are required and to conform the language in those requirements with the current requirements in Rule 11-01(a). Additionally, in conforming Rule 3-05(a)(1) with Rule 11-01(a), we propose to move the explanation that the acquisition of a

used in lieu of the equity method to account for an acquisition because the disclosure required by U.S. GAAP on a post-acquisition basis, and related requirements in Rules 4-08(g) and 3-09, includes summarized financial information or separate financial statements of the business after the acquisition.<sup>73</sup> We further propose replacing the term “furnish” with “file” throughout Rule 3-05 and Article 11 to make clear that the information required by Rule 3-05 and Article 11 must be filed with the Commission, as we believe that, at the time of adoption, the use of the term “furnished” in Rule 3-05 and Article 11 was not intended to mean that those disclosures were “not filed.”<sup>74</sup> In addition, Rule 3-05 requires “financial statements prepared and audited in accordance with this regulation.”<sup>75</sup> Consistent with current practice, the proposed amendments to Rule 3-05 would clarify that references to “this regulation” include the independence standards in Rule § 210.2-01 unless the business is not a registrant, in which case the applicable independence standards would apply. We are also proposing conforming clarifications in Rule 3-14 and proposed Rule 6-11.<sup>76</sup>

As another clarification, we propose to replace references to “business combination” with the term “business acquisition” to make clear that Rule 3-05 and Article 11 are not limited to

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business encompasses the acquisition of an interest in a business accounted for by the equity method from Rule 3-05(a)(1)(i) to proposed Rule 3-05(a)(2)(ii). Finally, we propose to clarify that a “business” that is a real estate operation is subject to Rule 3-14 instead of Rule 3-05.

<sup>73</sup> See proposed Rules 3-05(a)(2)(ii) and 3-14(a)(2)(ii).

<sup>74</sup> Throughout Rule 3-05 and Article 11, the regulatory text indicates that financial statements “shall be furnished.” See Rule 3-05(a)(1), (b)(1), (b)(2)(i), (b)(2)(ii), (b)(2)(iii), (b)(2)(iv), (b)(4)(ii), (b)(4)(iii), Rule 11-01(a) and Instruction 2 to Rule 11-02(b). At the time the Commission adopted Rule 3-05, there was no distinction between “furnished” and “filed.” See Rule 3-05 Adopting Release. As Securities Act and Exchange Act rules subsequently began to converge, with documents filed pursuant to the Exchange Act having exposure to Securities Act liability, some disclosure was required or permitted to be furnished but “not filed” for certain purposes. We believe that replacing the use of the term “furnished” with “filed” in the proposed amendment is consistent with the original intent and application of the securities laws.

<sup>75</sup> See Rule 3-05(a)(1).

<sup>76</sup> See proposed Rules 3-05(a)(1), 3-14 (a)(1), and 6-11(a)(1).

“business combinations” as that term is used in U.S. GAAP and IFRS-IASB.<sup>77</sup> The term “business combination” is defined by reference to the term “business,” which has developed differently under U.S. GAAP and IFRS-IASB from that term as defined in Rule 11-01(d). Because “business acquisition” also encompasses a “combination between entities under common control,” the proposed amendments would also replace this term in Rule 3-05 and Article 11.

Consistent with current practice, the proposed amendments would further provide that a registrant may continue to determine significance using amounts reported in its Form 10-K for the most recent fiscal year when the registrant has filed its Form 10-K after the acquisition consummation date, but before the date the registrant is required to file financial statements of the acquired business on Form 8-K.<sup>78</sup> We propose to permit rather than require use of the more recent Form 10-K in this circumstance to avoid creating an incentive for registrants to delay the filing of their Form 10-K.

Finally, the proposed amendments would replace the term “majority-owned” as used in Item 2.01 of Form 8-K with the term “subsidiaries consolidated,” as that term more accurately conveys which subsidiaries are required to be included in the registrant’s financial statements.<sup>79</sup> We believe these changes would not substantively alter the current Rule 3-05 requirements, but would facilitate compliance by providing clarity, codifying current practice, and updating the terminology used in our rules.

## **Request for Comment**

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<sup>77</sup> See *supra* note 10. We similarly propose to replace the term in the Instruction to Item 9.01 of Form 8-K.

<sup>78</sup> See proposed Rules 3-05(b)(3) and 11-01(b)(3)(ii). Pursuant to Rule 3-13, registrants have been permitted to omit Rule 3-05 Financial Statements if an acquired business is not significant using these amounts.

<sup>79</sup> Proposed Rule 3-05 uses the term “subsidiaries consolidated” to conform with the term as it is used elsewhere in Regulation S-X. See, e.g., Rule 1-02(w), Rule 3-01, and Rule 3-02.



25. We propose to clarify when financial statements and pro forma financial information are required and to update the language used in our rules. Are the proposed clarifications and updates appropriate? Are there further clarifications or other updates we should consider?
26. Is the proposed language related to independence standards sufficiently clear? Should we specify the “applicable independence standards”? If so, how should the “applicable independence standards” be specified? Are there circumstances where there are no “applicable independence standards”? In those circumstances, which independence standards should apply?

## **6. Foreign Businesses**

Regulation S-X permits the use of IFRS-IASB without reconciliation to U.S. GAAP in financial statements of foreign private issuers.<sup>80</sup> Rule 3-05 similarly permits the use of IFRS-IASB in financial statements of foreign businesses. We are proposing limited modifications to Rule 3-05 to 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 to use IFRS-IASB if it were a registrant,<sup>81</sup> and to permit foreign private issuers that prepare their financial statements using IFRS-IASB to provide Rule 3-05 Financial Statements prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP. In response to the 2015 Request for Comments, commenters generally supported expanding use of IFRS-IASB in financial statements of acquired businesses.<sup>82</sup>

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<sup>80</sup> See 17 CFR 210.4-01.

<sup>81</sup> This proposed amendment would be applicable to domestic and foreign registrants.

<sup>82</sup> See, e.g., letters from BDO, CalPERS, CAQ, DT, EY, Grant, KPMG, and PwC.

### a. Definition

Currently, the definitions of “foreign private issuer”<sup>83</sup> and “foreign business”<sup>84</sup> have different ownership requirements such that an acquired business could qualify to be a “foreign private issuer,” but not qualify to be a “foreign business.” For example, an acquired business may be majority-owned by persons who are U.S. citizens or residents and still qualify to be a “foreign private issuer” if it were a registrant and certain additional criteria were met,<sup>85</sup> but to qualify as a “foreign business,” it must be majority-owned by persons who are not U.S. citizens or residents. The divergent ownership criteria in the two definitions has created a circumstance where an acquired business that does not meet the definition of foreign business, but would otherwise be permitted to present its financial statements using IFRS-IASB as a foreign private issuer, is not permitted to use financial statements prepared in accordance with IFRS-IASB for its Rule 3-05 Financial Statements even when those financial statements are already available. Instead, the Rule 3-05 Financial Statements must be prepared in accordance with U.S. GAAP,<sup>86</sup> which can result in a significant cost to the registrant. In circumstances where the acquired business has a sufficient foreign nexus to meet the definition of a foreign private issuer, we

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<sup>83</sup> See Rule 405. The term “foreign private issuer” means any foreign issuer, other than a foreign government, that does not meet the following criteria as of the last business day of its most recently completed second fiscal quarter: (i) more than 50% of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and (ii) any of the following: (a) the majority of the executive officers or directors are United States citizens or residents; (b) more than 50% of the assets of the issuer are located in the United States; or (c) the business of the issuer is administered principally in the United States.

<sup>84</sup> See 17 CFR 210.1-02(l).

<sup>85</sup> See *supra* note 83.

<sup>86</sup> Alternatively, the Rule 3-05 Financial Statements may be prepared in accordance with a basis of accounting other than U.S. GAAP provided a reconciliation to U.S. GAAP under Item 18 of Form 20-F is included. See *Financial Statements of Significant Foreign Equity Investees and Acquired Foreign Businesses of Domestic Issuers and Financial Schedules*, Release No. 33-7118 (Dec. 13, 1994) [59 FR 65632 (Dec. 20, 1994)] (“1994 Acquired Foreign Business Release”).

believe financial statements prepared in accordance with IFRS-IASB would provide sufficient information for investors.

We therefore propose to revise Rule 3-05 to permit Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP<sup>87</sup> if the acquired business would qualify to use IFRS-IASB if it were a registrant.<sup>88</sup> In circumstances where the registrant presents its financial statements in U.S. GAAP, the pro forma financial information reflecting the acquisition will continue to be required to be presented in U.S. GAAP.

#### **b. Reconciliation Requirement**

Currently, if Rule 3-05 Financial Statements of a foreign business are prepared on a basis of accounting other than U.S. GAAP or IFRS-IASB, such as home-country GAAP, the Rule 3-05 Financial Statements must be reconciled to U.S. GAAP.<sup>89</sup> If the registrant in this case were a foreign private issuer that presents its financial statements using IFRS-IASB, this one-time presentation of the U.S. GAAP reconciling information in financial statements of the acquired business would likely be the only required U.S. GAAP information in any of the registrant's filings and could be costly to produce. We believe that Rule 3-05 Financial Statements that include IFRS-IASB reconciling information of the acquired foreign business would provide more comparable information and better facilitate analysis of the financial statements.

We therefore propose to permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile Rule 3-05 Financial Statements prepared using home

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<sup>87</sup> Under the existing and the proposed rule, acquired foreign business financial statements may use IFRS-IASB without reconciliation to U.S. GAAP, even when the registrant prepares its financial statement using U.S. GAAP.

<sup>88</sup> See proposed Rule 3-05(d).

<sup>89</sup> See Item 17 of Form 20-F and 1994 Acquired Foreign Business Release.

country GAAP to IFRS-IASB rather than U.S. GAAP.<sup>90</sup> The reconciliation to IFRS-IASB would be required generally to follow the form and content requirements in Item 17(c) of Form 20-F.

### **Request for Comment**

27. Is the proposed revision to permit in certain circumstances Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP appropriate? Are there other requirements that could improve the information to investors?

28. Is the proposed revision to permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile acquired foreign business financial statements to IFRS-IASB appropriate? Would continuing to require reconciliation to U.S. GAAP provide better information to investors? Are there other requirements that could improve the information to investors?

### **7. Smaller Reporting Companies and Issuers Relying on Regulation A**

Rule 8-04 provides smaller reporting company disclosure requirements for the financial statements of businesses acquired or to be acquired that substantively differ from the existing requirements in Rule 3-05 in four ways:

- Rule 8-04 permits acquired business financial statements to be prepared in accordance with the form and content required by Article 8, rather than the form and content specified elsewhere in Regulation S-X;<sup>91</sup>

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<sup>90</sup> See proposed Rule 3-05(c).

<sup>91</sup> Article 8 allows smaller reporting companies to, among other things, omit certain footnote disclosures that would be required by Article 4. Article 8 also requires fewer line items on the face of interim financial statements.

- Rule 8-04 only requires up to two years of acquired business historical financial statements;
- Rule 8-04 does not explicitly permit the omission of previously filed financial statements once the operating results of the acquired business have been included in the audited consolidated financial statements of the registrant for a complete fiscal year; and
- the ability to exclude from a registration statement separate financial statements of the acquired or to be acquired business in certain circumstances is based on the effective date of the registration statement rather than the date of the relevant final prospectus or prospectus supplement.

In connection with offerings made pursuant to Regulation A,<sup>92</sup> Part F/S of Form 1-A (“Part F/S”)<sup>93</sup> directs an entity relying on Regulation A to present financial statements of businesses acquired or to be acquired,<sup>94</sup> as specified by Rule 8-04, but permits the periods presented to be those applicable to Regulation A issuers rather than the periods specified by Article 8.<sup>95</sup>

In order to simplify the application of our rules by focusing registrants on the more detailed and better understood provisions of Rule 3-05, we propose to revise Rule 8-04 to direct

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<sup>92</sup> 17 CFR 230.251 through 263.

<sup>93</sup> 17 CFR 239.90.

<sup>94</sup> See paragraph (b)(7)(iii) of Part F/S.

<sup>95</sup> As mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act (Pub. L. 115-174, 132 Stat. 1296 (2018)), the Commission in December 2018 revised Rule 251(b) under the Securities Act to permit entities subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act to conduct exempt offerings under Regulation A. See *Amendments to Regulation A*, Release No. 33-10591 (Dec. 19, 2018) [84 FR 520 (Jan. 31, 2019)]. Such reporting companies are required, at a minimum, to comply with the requirements of Part F/S of Form 1-A. However, if at the time a reporting company files a Form 1-A, it has made publicly available more recent audited or reviewed financial statements prepared in accordance with the standard required for the registrant’s Exchange Act reports, including such financial statements in the offering statement may be necessary to make the required statements therein, in light of the circumstances under which they are being made, not misleading. See 17 CFR 230.252.

registrants to Rule 3-05 for the requirements relating to the financial statements of businesses acquired or to be acquired, other than for form and content requirements for such financial statements, which would continue to be prepared in accordance with Rules 8-02 and 8-03.<sup>96</sup> Additionally, because Part F/S of Form 1-A refers to Rule 8-04, the proposed revisions to Rule 8-04 would apply to issuers relying on Regulation A. As a result, under the proposed amendments, smaller reporting companies would continue to be required to provide up to two years of acquired business historical financial statements and Regulation A issuers would continue to be permitted to present the periods applicable under Regulation A.<sup>97</sup>

Additionally, under the proposed amendments, a smaller reporting company would be eligible to exclude acquired business financial statements from a registration statement if the business acquisition was consummated no more than 74 days prior to the date of the relevant final prospectus or prospectus supplement, rather than 74 days prior to the effective date of the registration statement as under current Rule 8-04(c)(4).<sup>98</sup> We believe it is appropriate to consistently look to the date of the final prospectus or prospectus supplement,<sup>99</sup> as Rule 3-05

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<sup>96</sup> Rule 3-05(b)(1) currently requires financial statements specified in §§210.3-01 and 210.3-02 for the business to be acquired. Similarly, Rule 3-05(b)(2) also references §§210.3-01 and 210.3-02. Under our proposal, smaller reporting companies would apply §210.3-05 but would substitute §§210.8-02 and 210.8-03, as applicable, wherever §210.3-05 references §§ 210.3-01 and 210.3-02. In this way, our proposal is intended to apply the election permitted for smaller reporting companies to prepare their financial statements in accordance with the form and content requirements in Article 8 rather than the other form and content requirements specified elsewhere in Regulation S-X (subject to the exceptions noted in §210.8-01 Preliminary Note 2 to Article 8) to businesses acquired by smaller reporting companies.

<sup>97</sup> Additionally, in accordance with current practice, the proposed rule would expressly permit smaller reporting companies to omit such financial statements if the acquired business has been included in the registrant's results for a complete fiscal year. *See* further discussion of omission of Rule 3-05 Financial Statements in Section II.B.1 above. We also propose to add references to Rule 8-04 in Rule 3-06 and to Rule 3-06 in Note 6 to Article 8 to expressly permit smaller reporting companies to file financial statements covering a period of nine to 12 months to satisfy the requirement for filing financial statements for a period of one year for an acquired business.

<sup>98</sup> *See* proposed Rule 3-05(b)(4)(i)(B).

<sup>99</sup> *See* 1996 Streamlining Release, *supra* note 13 (noting that the date of an offering is specified as the date of the final prospectus or prospectus supplement relating to the offering).

currently does, because that date could be later than the effective date, particularly in the case of a delayed offering, which some smaller reporting companies are now permitted to conduct.<sup>100</sup>

### **Request for Comment**

29. Would the proposed revisions to Rule 8-04 to direct smaller reporting companies and Regulation A issuers to Rule 3-05 while still permitting them to rely on the form and content requirements in Rules 8-02 and 8-03 simplify the application of our rules by focusing registrants on the more detailed and better understood provisions of Rule 3-05? Are there other changes to the Rule 8-04 requirements that we should consider?
30. For purposes of excluding acquired business financial statements from a registration statement, is the proposed revision to require smaller reporting companies to look to the date of the relevant final prospectus or prospectus supplement instead of the effective date of the registration statement appropriate? Why or why not?
31. Our proposal to no longer require Rule 3-05 Financial Statements once the operating results of the acquired business have been included in the audited consolidated financial statements of the registrant for a complete fiscal year (*see* Section II.B.1 above) would also apply to smaller reporting companies pursuant to our proposed revisions to Rule 8-04. Is permitting smaller reporting companies to omit financial statements under these circumstances appropriate? Are there specific revisions or information requirements we should consider for smaller reporting companies?
32. Should the proposed changes to Rule 8-04 apply to offerings made pursuant to Regulation A? Should we revise the proposals to better accommodate Regulation A issuers and investors? If so, what revisions should we make and why?

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<sup>100</sup> *See* General Instruction I.B.6 of Form S-3 and 2018 SRC Amendments, *supra* note 16.

**B. Proposed Amendments Relating to Rule 3-05 Financial Statements Included in Registration Statements and Proxy Statements**

**1. Omission of Rule 3-05 Financial Statements for Businesses That Have Been Included in the Registrant's Financial Statements**

*Overview of the Application of the Current Rule*

Current Rule 3-05(b)(4)(iii) generally permits Rule 3-05 Financial Statements to be omitted 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. However, Rule 3-05 Financial Statements are required to be included when they have not been previously filed or when the Rule 3-05 Financial Statements have been previously filed, but the acquired business is of major significance to the registrant.

*Rule 3-05 Financial Statements Not Previously Filed*

If Rule 3-05 Financial Statements have not been previously filed, they must be provided even if the acquired business is included in post-acquisition audited results. Thus, a registrant that acquired a significant business during the earliest of the three years for which it presents financial statements, and has reported the combined results in audited financial statements since the acquisition, would still be required to file separate Rule 3-05 Financial Statements for that acquired business if the Rule 3-05 Financial Statements have not been previously filed.<sup>101</sup> The staff has historically not objected, however, to registrants reducing the Rule 3-05 Financial Statement periods presented by the equivalent period that the acquired business is included in the registrant's post-acquisition audited results.<sup>102</sup>

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<sup>101</sup> This issue arises most often for initial registration statements under the Securities Act and Exchange Act since an existing Exchange Act reporting company would generally have been required to file Rule 3-05 Financial Statements on a Form 8-K within approximately 75 days after acquisition of a significant business.

<sup>102</sup> This is limited to circumstances where there is no gap between the latest date of the pre-acquisition audited financial statements of the acquired business and the earliest date of the registrant's audited post-acquisition



*Rule 3-05 Financial Statements Previously Filed for an Acquisition that was of Major Significance*

Under current Rule 3-05(b)(4)(iii), registrants must also continue to present Rule 3-05 Financial Statements that have been previously filed if the acquired business is of such significance to the registrant that omission of those 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 that an acquired business that met at least one of the significance tests at the 80% level at the date of the acquisition would require the registrant to continue to file the financial statements of the acquired business for such periods prior to the purchase as may be necessary when added to the time for which audited income statements after the purchase are filed to cover the equivalent of the period specified in Rule 3-02.<sup>103</sup> Notwithstanding the rule's reference to materiality, in practice the rule is typically applied, consistent with this example, on the basis of quantitative significance determinations.<sup>104</sup> The result of the practical application of the "major significance" exception is that, for example, if an acquisition that occurred two years ago was significant at the 80% level at the time of the acquisition, one year of previously filed Rule 3-05 Financial Statements will continue to be

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results. See FRM, *supra* note 40, at Section 2030.4 "Initial Registration Statements – Using Pre-Acquisition and Post-Acquisition Audited Results."

<sup>103</sup> See Rule 3-05(b)(4)(iii). Rule 3-02 states that there shall be filed, for the registrant and its subsidiaries consolidated and for its predecessors, audited statements of income and cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet being filed or such shorter period as the registrant (including predecessors) has been in existence. An emerging growth company may provide audited statements of income and cash flows for each of the two fiscal years preceding the date of the most recent audited balance sheet (or such shorter period as the registrant has been in existence) in its initial registration statement.

<sup>104</sup> See, e.g., FRM, *supra* note 40, at Section 2040.2 "Major Significance" and "Previously Filed Acquiree Financial Statements."

provided regardless of whether post-acquisition activities have diminished the relative significance of the acquired business.

*Proposed Amendments Regarding the Omission of Rule 3-05 Financial Statements*

We are proposing to no longer require Rule 3-05 Financial Statements in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements for a complete fiscal year.<sup>105</sup> This change would eliminate the requirement that Rule 3-05 Financial Statements be provided when they have not been previously filed or when they have been previously filed but the acquired business is of major significance.

The “not previously filed” exception requires those registrants filing initial registration statements to test the significance of acquisitions that occurred during the earliest years for which the registrant is required to provide its historical financial statements and, if significant, to provide pre-acquisition financial statements of the acquired business. This requirement can delay a registrant’s offering and thereby its access to capital while providing information that is often less meaningful to investors because the utility of pre-acquisition periods diminishes over time after the acquired business is reflected in post-acquisition results and the post-acquisition results of the combined business are generally not comparable to the pre-acquisition results of the acquired business.<sup>106</sup>

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<sup>105</sup> The proposed amendments would require inclusion in all twelve months of the registrant’s most recently completed audited fiscal year. They do not permit reducing the twelve month period through analogy to Rule 3-06 or by the number of months of pre-acquisition historical financial statements that may be provided.

<sup>106</sup> See FRM, *supra* note 40, at Section 2030.4. The accommodation currently provided by Commission staff does not sufficiently ameliorate these effects and often results in financial statements of the acquired business for a pre-acquisition stub period ending at a date during a fiscal period such that the financial statements depict partial, rather than complete, reporting periods that do not coincide with the end of either the acquired

We also propose to eliminate the “major significance” exception. As with not previously filed information, the utility of pre-acquisition periods diminishes over time after the acquired business is reflected in post-acquisition results. We further observe that the “major significance” exception was established prior to requirements for electronic filing, which has made previously filed financial information about the acquired business more readily accessible through the Commission’s EDGAR filing system. Consequently, we believe this exception is no longer necessary.

We believe inclusion of post-acquisition results in the registrant’s audited financial statements for a complete fiscal year should generally provide investors with sufficient information to make informed investment decisions about the registrant.<sup>107</sup> The requirement for management to prepare Rule 3-05 Financial Statements and a third party to audit those financial statements can be costly and adds preparation time for the financial statements, which can affect a registrant’s time to market and delay its access to capital. Where the significant acquisition will have occurred over a year before, and information about the acquired business that is material to the registrant would generally have been incorporated into the registrant’s audited historical financial statements for a complete fiscal year or otherwise provided pursuant to the requirements of 17 CFR 210.4-01(a) and 17 CFR 229.303, we do not believe it is necessary to require registrants to provide Rule 3-05 Financial Statements.

### **Request for Comment**

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business’s or the registrant’s fiscal periods. Moreover, because these are staff accommodations, they lack the legal significance of a Commission rule.

<sup>107</sup> Further, even without the major significance requirement to include some, but not all, of the previously filed pre-acquisition financial statements of the acquired business, Regulation S-X provides that a registrant shall 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.” *See* 17 CFR 210.4-01(a).

33. Is our proposal to no longer require Rule 3-05 Financial Statements once the acquired business is reflected in filed post-acquisition audited consolidated financial statements of the registrant for a complete fiscal year appropriate? Would the proposed revisions simplify the application of the rule and reduce costs for registrants?
34. Would the proposed amendments affect the sufficiency of information available to investors? If so, should we continue to require Rule 3-05 Financial Statements if they have not been previously filed or if the acquisition was of major significance? Alternatively, what information about an acquired business is most important to investors once the acquired business has been depicted in the registrant's post-acquisition audited consolidated financial statements for a complete fiscal year that is not otherwise provided pursuant to existing requirements, like those for management's discussion and analysis, and what changes could we make to ensure that investors receive such information while reducing the burden on registrants of preparing unnecessary disclosure?

## **2. Use of Pro Forma Financial Information to Measure Significance**

Significance determinations are required to be made by comparing the most recent annual consolidated financial statements of the acquired business to those of the registrant filed at or prior to the date of acquisition. A registrant is permitted to use pro forma, rather than historical, financial information if the registrant made a significant acquisition subsequent to the latest fiscal year-end and filed its Rule 3-05 Financial Statements and pro forma financial information on Form 8-K.<sup>108</sup> There is no analogous provision in Rule 3-05 for registrants to use pro forma financial information depicting significant dispositions or for registrants filing initial registration statements. In considering whether, pursuant to Rule 3-13 and delegated authority, to permit

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<sup>108</sup> 17 CFR 210.3-05(b)(3).

omission or substitution of acquired business financial statements in initial registration statements of registrants growing through acquisition, Commission staff has considered the results of significance tests using pro forma financial information.<sup>109</sup> In response to the 2015 Request for Comment, some commenters recommended establishing requirements to determine significance in these circumstances in a manner that reduces complexity and provides financial statements that are meaningful to investors.<sup>110</sup>

We propose to expand the circumstances in which a registrant can use pro forma financial information for significance testing. Specifically, for all filings that require Rule 3-05 Financial Statements and Rule 3-14 Financial Statements, we propose to permit registrants to measure significance using filed pro forma financial information that only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end for which the registrant's financial statements are required to be filed, subject to the following conditions:

- the registrant has filed Rule 3-05 Financial Statements or Rule 3-14 Financial Statements for any such acquired business; and
- the registrant has filed the pro forma financial information required by Article 11 for any such acquired or disposed business.<sup>111</sup>

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<sup>109</sup> See *supra* note 43. See also Staff Accounting Bulletin No. 80, *Application of Rule 3-05 in Initial Public Offerings* (“SAB 80”). Consistent with the staff’s exercise of delegated authority in response to requests under Rule 3-13, SAB 80 states that the staff will not object if significance is measured using the alternative method specified in SAB 80. The SAB 80 method is similar to Rule 3-05 in its use of more recent pro forma financial information of the registrant. It differs from Rule 3-05 in that it: uses pro forma rather than historical financial information of the acquired business; uses pro forma financial information of the registrant that was not previously filed; and does not reflect the current, higher significance thresholds in Rule 3-05. The accommodations in SAB 80 are complex and seldom used by registrants, in part because they require the acquired businesses to remain discrete and substantially intact after acquisition.

<sup>110</sup> See, e.g., letters from ABA-Committees, CAQ, DT, EY, and Grant.

<sup>111</sup> We propose to include these provisions in Rule 11-01(b)(3) and to further revise Rule 3-05(b)(3) and Rule 3-14(b)(2) to replace the existing guidance with a specific reference to Rule 11-01(b)(3).

We additionally propose to revise Rule 11-01(b)(1) to add a reference to Rule 11-02 to clarify that registrants may not include Management's Adjustments<sup>112</sup> when using pro forma financial information to determine significance. Rather, the pro forma financial information must be limited to the applicable subtotals that combine the historical financial information of the registrant and the acquired business and Transaction Accounting Adjustments.<sup>113</sup>

We believe that these proposed amendments and clarifications would provide registrants with the flexibility to more accurately determine the relative significance of an acquired or disposed business to the ongoing operations of the registrant, including for those filing an initial registration statement, without inadvertently delaying or accelerating the filing of pro forma financial information that might occur if we required use of such pro forma financial information to determine significance. The proposed amendments would also simplify the application of the rule by including in a single location the description of the financial statements used to measure significance for purposes of Rules 3-05 and 3-14 and Form 8-K.

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35. Are the proposed revisions to permit significance testing based on pro forma financial information in these circumstances appropriate? Are the proposed revisions to permit the use of pro forma financial information for all filings that require Rule 3-05 Financial Statements and Rule 3-14 Financial Statements appropriate? Should certain filings that require such financial statements be precluded from using pro forma financial information to measure significance?

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<sup>112</sup> See Section II.D.1. below.

<sup>113</sup> See *id.* We also are proposing amendments to Rule 11-01(b)(3) to indicate that the pro forma information that is used to measure significance may only give effect to the subsequently acquired or disposed business and may not give effect to other transactions, such as the use of proceeds from an offering.

36. Would the amendments provide flexibility to make a more accurate determination of significance without delaying or accelerating the required filing of pro forma financial information? Should we require significance to be determined using pro forma financial information in the circumstances we describe? Why or why not? If yes, how could we modify our proposal so that it does not delay or accelerate the required filing of pro forma financial information? Would the amendments simplify application of the rule? Would they reduce costs for registrants?

### **3. Disclosure Requirements for Individually Insignificant Acquisitions**

Under the existing rules, audited historical pre-acquisition financial statements are generally not required if an acquired or to be acquired business: (1) does not exceed 20% significance, or (2) does not exceed 50% significance and the acquisition has not yet occurred or the date of the final prospectus or prospectus supplement relating to an offering as filed with the Commission pursuant to §230.424(b) of this chapter is no more than 74 days after consummation and the financial statements have not been previously filed.<sup>114</sup> However, if the aggregate impact of “individually insignificant businesses”<sup>115</sup> acquired since the date of the most recent audited balance sheet filed for the registrant exceeds 50%, audited historical pre-acquisition financial

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<sup>114</sup> See Rule 3-05(b)(4)(i).

<sup>115</sup> In the 1996 Streamlining Release, Rule 3-05 was amended to permit the exclusion of historical financial statements for certain significant acquisitions that did not exceed 50% significance. See Rule 3-05(b)(4)(i). However, we believe that Rule 3-05(b)(4) was not intended to circumvent the requirement in Rule 3-05(b)(2) to consider the aggregate significance of all acquired businesses for which financial statements were not yet filed. To do otherwise could lead to the presentation of financial statements for less than a mathematical majority of businesses acquired since the most recent audited balance sheet that have an aggregate significance in excess of 50%. For these reasons, the proposals would codify staff interpretation 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 by Rule 3-05(b)(4) because of the 75-day filing period. See FRM, *supra* note 40, at Section 2035.2.

statements covering at least the substantial majority of the businesses acquired must be included in a registration statement or proxy statement.<sup>116</sup> Registrants also must provide related pro forma financial information based on the requirements of Article 11.<sup>117</sup>

The practical effect of this requirement is that registrants often provide separate, audited historical financial statements for acquired businesses that are individually not material to the registrant, and pro forma financial information that does not fully depict the aggregate effect of the “individually insignificant businesses.”<sup>118</sup> Further, the requirements can have implications for business acquisition negotiations, as registrants may need to negotiate a requirement for the seller to timely provide historical financial statements of an insignificant business to cover the possibility that a future acquisition may trigger the Rule 3-05 “individually insignificant businesses” requirements.<sup>119</sup> In response to the 2015 Request for Comment, commenters

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<sup>116</sup> 17 CFR 210.3-05(b)(2)(i). “Substantial majority” has been applied in practice to be the mathematical majority (i.e., businesses constituting more than 50% of the relevant test (investment, asset or income) on which the businesses were determined to be significant in the aggregate) See FRM, *supra* note 40, at Section 2035.3 “*Financial Statements Required – Mathematical Majority.*”

<sup>117</sup> Rule 11-01(a) specifies conditions for which pro forma financial information must be presented. Those conditions do not explicitly discuss the aggregate significance of individually insignificant businesses, however they do include, “consummation of a significant business combination or a combination of entities under common control [that] has occurred or is probable” and “consummation of other events or transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors.” Further, Rule 11-01(c) links the requirement for pro forma financial information for a significant business acquisition to the presentation of separate financial statements of the acquired business. Taken together, these requirements provide that if separate financial statements of the substantial majority of individually insignificant businesses are presented, pro forma financial information depicting their effects must also be presented.

<sup>118</sup> Article 11 only requires pro forma financial information for an acquisition for which Rule 3-05 Financial Statements are required, and the pro forma financial information will only reflect the acquisitions selected for the Rule 3-05 Financial Statements. Thus, for example, if the aggregate of 16 individually insignificant acquisitions is 80% significant, with each at 5%, a registrant would currently be required to provide pre-acquisition audited historical financial statements for nine of the individually insignificant businesses. Thus, the pro forma financial information would only depict the effect of those nine acquisitions constituting 45% of the registrant’s post-acquisition assets or income.

<sup>119</sup> Under the proposal, registrants would have to negotiate the timely provision of historical balance sheet and income statement information for each acquisition necessary to present pro forma financial information depicting their aggregate effects in all material respects when aggregate significance exceeds 50%, but historical financial statements only for acquisitions that are required to be reported on Form 8-K (i.e., individual



questioned the utility of audited financial statement requirements for individually insignificant acquisitions.<sup>120</sup> Some of these commenters recommended more frequent and timely reporting of pro forma financial information for individually insignificant acquisitions instead of the current requirements.<sup>121</sup>

We propose revising our rules to improve the information provided to investors, reduce immaterial disclosure and clarify the requirements. Similar to existing requirements, proposed Rule 3-05(b)(2)(iv) would require disclosure if the aggregate impact of businesses acquired or to be acquired since the date of the most recent audited balance sheet filed for the registrant, for which financial statements are either not required by paragraph (b)(2)(i) or are not yet required based on paragraph (b)(4)(i), exceeds 50%.<sup>122</sup> The proposed rule, however, would require registrants to provide pro forma financial information depicting the aggregate effects of all such businesses in all material respects and pre-acquisition historical financial statements only for those businesses whose individual significance exceeds 20% but are not yet required to file financial statements.<sup>123</sup>

We believe the proposed amendments would both improve the information provided to investors and reduce burdens on registrants of providing audited historical financial statements

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significance exceeds 20%). However, the proposed rule could accelerate reporting of historical financial statements for these acquisitions (i.e., individual significance exceeds 20%) in certain registration statements and proxy statements if the combined acquisitions exceed the 50% threshold.

<sup>120</sup> See letters from ABA, BDO, CAQ, DT, EEI/AGA, EY, Grant, and PwC.

<sup>121</sup> See letters from ABA, EY, and PwC. ABA and EY indicated that a registrant should provide pro forma information when the aggregate effect of individually insignificant acquisitions completed in a fiscal year becomes significant to the registrant.

<sup>122</sup> For clarity, we are proposing to specifically describe the affected businesses in the rule without reference to the term “individually insignificant businesses.”

<sup>123</sup> See proposed Rule 3-05(b)(2)(iv) and proposed revisions to Rule 11-01(c). Further, we propose to revise Rule 11-01(c) to clarify that the exception that would otherwise permit pro forma financial information not to be provided when separate financial statements of the acquired business are not included in the filing does not apply where the aggregate impact is significant as determined by proposed Rules 3-05(b)(2)(iv) or 3-14(b)(2)(i)(C).

for immaterial acquisitions. Preparing disclosure about immaterial acquisitions and negotiating with sellers to timely provide historical financial statements for them can increase the cost of registration and delay access to capital. In addition, requiring pro forma financial information that shows the aggregate effect of the acquired businesses for which financial statements are either not required or not yet required in all material respects rather than only giving effect to a mathematical majority of such businesses, would make it easier for investors to understand the overall effect of those acquisitions on the registrant.

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37. Is the proposed amendment to require registrants to provide Rule 3-05 Financial Statements only for those acquisitions whose individual significance exceeds 20% appropriate? Would the proposed amendment improve the information provided to investors? Would it instead reduce the amount of material information that is available? If so, would this reduction be mitigated by the proposal to require pro forma financial information depicting the aggregate impact of the acquisitions for which financial statements are either not required or not yet required in all material respects? Would the proposed amendment simplify the application of the rule and reduce the burden of preparing the information for registrants?
38. Is the proposed amendment to require registrants to provide pro forma financial information depicting the aggregate impact of the acquisitions for which financial statements are either not required or not yet required in all material respects appropriate? Would the proposed revision improve the information provided to investors? Would the proposed amendment simplify the application of the rule and reduce the burden of preparing the information for registrants?

39. As proposed, the aggregate impact determination in Rule 3-05(b)(2)(iv) would exclude acquired businesses subject to Rule 3-14. Similarly, the proposed Rule 3-14(b)(2)(i)(C) aggregate impact determination described in Section II.C. below would exclude acquired businesses subject to Rule 3-05. Since a registrant could have both types of acquisitions within a reporting period, should we revise the proposed aggregate impact determinations in Rule 3-05 and Rule 3-14 to include all such acquired business?

**C. Rule 3-14 - Financial Statements of Real Estate Operations Acquired or to be Acquired**

Rule 3-14 differs from Rule 3-05, in part, because unique industry considerations warrant differentiated disclosure. For example, in previous amendments to Rule 3-14 to require only one year of Rule 3-14 Financial Statements to be provided in most circumstances, the Commission recognized that audited financial statements for a real estate operation are rarely available from the seller without additional effort and expense because most real estate managers do not maintain their books on a U.S. GAAP basis or obtain audits.<sup>124</sup> The Commission further noted that historical financial statements for real property do not usually provide significant information about the trends and factors that are most likely to affect future operations, such as demographic information, application of managerial techniques, and competition.<sup>125</sup> As a result, in addition to requiring Rule 3-14 Financial Statements for one year in most circumstances, Rule 3-14 also requires the registrant to describe with specificity in the filing the material factors

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<sup>124</sup> See *Publication of Revisions to the Division of Corporation Finance's Guide 5 and Amendment of Related Disclosure Provisions*, Release No. 33-6405 (June 3, 1982) [47 FR 25120 (June 10, 1982)] and *Proposed Revision of Guide 60 and Related Disclosure Provisions*, Release No. 33-6354 (Oct. 7, 1981) [46 FR 50553 (Oct. 14, 1981)]. When Rule 3-14 was initially adopted, it required audited abbreviated income statements for the three most recent years. The requirements have not been substantively modified since they were first introduced in Form S-11 in 1961, except to reduce the number of years of financial statements required in most circumstances from three to one.

<sup>125</sup> *Id.*, at 50558.

it considered in assessing the real estate operation, including sources of revenue (including, but not limited to, competition in the rental market, comparative rents, and occupancy rates) and expense (including, but not limited to, utility rates, property tax rates, maintenance expenses, and capital improvements anticipated). The disclosure must also indicate that the registrant is not aware of any other material factors relating to the specific real estate operation that would cause the reported financial statements not to be indicative of future operating results.<sup>126</sup>

We propose to align Rule 3-14 with Rule 3-05 where no unique industry considerations exist because the rules have similar objectives. We also propose to establish or clarify the application of Rule 3-14 regarding scope of the requirements, determination of significance, need for interim income statements, and special provisions for blind pool offerings.

#### **1. Align Rule 3-14 with Rule 3-05**

We are proposing amendments to Rule 3-14 consistent with the new proposals for Rule 3-05 discussed above.<sup>127</sup> We have found no unique industry considerations that warrant differentiated treatment of real estate operations in these areas, and believe that aligning Rule 3-14 with Rule 3-05 will reduce complexity by standardizing the requirements for acquired businesses overall while retaining the industry specific disclosure necessary for investors to make informed investment decisions. In response to the 2015 Request for Comment, commenters generally supported aligning these rules where appropriate.<sup>128</sup>

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<sup>126</sup> See Rules 3-14(a)(1)(ii) and 3-14(a)(1)(iii).

<sup>127</sup> We are also proposing to align the rules regarding the timing of financial statements and use of the term “furnished” discussed in Section II.A.5 and note 74; the Investment Test discussed in Section II.A.1; and the required disclosures discussed in Section II.A.4, II.A.6, II.B.1, II.B.2, and II. B.3.

<sup>128</sup> See, e.g., letters from CAQ, DT, EY, Grant, and PwC.

*Significance Thresholds.* We propose to align the Rule 3-14 significance threshold for individual acquisitions to the 20% threshold<sup>129</sup> for acquired businesses in Rule 3-05. We also propose to align the Rule 3-14 significance threshold for the aggregate impact of acquisitions for which financial statements are not required or not yet required and for individual probable acquisitions to the exceeds 50% level for registration statements and proxy statements.<sup>130</sup> When the Commission last increased the significance thresholds for Rule 3-05 in 1996, it noted that commenters supported modification of Rule 3-14 as well, but it deferred any changes until the rule could be evaluated as part of a more comprehensive disclosure scheme.<sup>131</sup> We believe that these significance thresholds should be the same for all acquired and to be acquired businesses, regardless of whether the business is a real estate operation.

*Years of Required Financial Statements for Acquisitions from Related Parties.* We propose to eliminate the Rule 3-14 requirement to provide three years of financial statements for acquisitions from related parties to conform it to Rule 3-05.<sup>132</sup> The Rule 3-05 Adopting Release

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<sup>129</sup> Rule 3-14 refers to acquisitions that are “significant;” however, neither “significant property” nor “significant real estate operation” are defined in Regulation S-X. Current practice looks to the 10% significance threshold in the definition of “significant subsidiary” in Rule 1-02(w) when determining “significance” under Rule 3-14. See FRM, *supra* note 40, at Section 2310.1 “*Registration Statements and Proxy Statements - Requirements.*” The proposed amendments would make the 20% threshold explicit in Rule 3-14.

<sup>130</sup> Rule 3-14 Financial Statements are currently required when the registrant has acquired or proposes to acquire a group of properties which in the aggregate are significant. In practice, consummated and probable acquisitions since the date of the most recent audited balance sheet that are less than 10% significant are aggregated and, if the significance of the aggregated group exceeds 10%, Rule 3-14 Financial Statements are provided for each acquisition that is 5% or more significant and for enough other acquisitions in order to cover the substantial majority of the group. See FRM, *supra* note 40, at Section 2320. By aligning proposed Rule 3-14 with proposed Rule 3-05, the proposals would remove ambiguity by defining which businesses must be aggregated and the significance threshold that applies and by clarifying that this requirement applies only to certain registration statements and proxy statements and not to Form 8-K.

<sup>131</sup> See 1996 Streamlining Release, *supra* note 13.

<sup>132</sup> When the Commission adopted Rule 3-14 in 1980, it was based on Item 6(b) of Form S-11. Item 6(b) required audited summary financial data of a property or group of properties in an abbreviated form similar to what is required today in Rule 3-14 Financial Statements. In 1982, when the Commission reduced the number of years of required Rule 3-14 Financial Statements from three years to one year for most acquisitions, the Commission retained the requirement for three years for acquisitions from related parties.

states that because certain acquisitions have a greater impact on a registrant than others, the number of years of financial statements required for Rule 3-05 Financial Statements is based on significance using a sliding scale approach.<sup>133</sup> Furthermore, the release does not identify the source of acquisitions (i.e., from related parties versus third parties) as a factor driving the potential impact of acquisitions on the registrant. Thus, because we are not aware of any unique industry considerations that warrant different requirements in Rule 3-14 for acquisitions from related parties, we believe that acquisitions of real estate operations should be treated similarly to other businesses<sup>134</sup> and conformed to Rule 3-05, which does not differentiate the number of periods for which historical financial statements are required based on whether the seller is a related party or not.<sup>135</sup>

*Application of Rule 3-06.* We propose to align the application of Rule 3-14 with Rule 3-05 by revising Rule 3-06 to permit the filing of financial statements covering a period of nine to 12 months to satisfy the requirement for filing financial statements for a period of one year for an acquired or to be acquired real estate operation.<sup>136</sup> The Commission adopted Rule 3-06 in 1989

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<sup>133</sup> See Rule 3-05 Adopting Release, *supra* note 11.

<sup>134</sup> It is common for transactions in initial registration statements in the real estate industry to involve the combination of multiple entities with related or common ownership. In those circumstances, certain acquired entities may be designated as a predecessor of the registrant. For purposes of financial statements, an acquired business is designated as a predecessor when a registrant succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired. See the definition of "predecessor" in Securities Act Rule 405. Financial statements specified in Rules 3-01 and 3-02 are required for acquisitions of a predecessor, including those from related parties, rather than Rule 3-05 or Rule 3-14 Financial Statements. This proposal will not affect those requirements.

<sup>135</sup> While the need for Rule 3-14 Financial Statements is based on significance, Rule 3-14 does not use a sliding scale type requirement; rather, due to the nature of the acquisitions, only one year of financial statements is required, if significant, along with supplemental information disclosing the material factors considered by the registrant in assessing the real estate operation. See *supra* note 124.

<sup>136</sup> See Rule 3-06.

to codify staff practice at the time regarding Rule 3-05 Financial Statements.<sup>137</sup> Although Rule 3-06 only addresses financial statements of business acquisitions under Rule 3-05, we believe that there are no industry-specific reasons for applying Rule 3-14 differently and therefore that Rule 3-06 should equally apply to Rule 3-14 Financial Statements due to the similar purposes of Rule 3-05 and Rule 3-14.

*Timing of filings.* We propose to amend Rule 3-14 to include the same period for the filing of Rule 3-14 Financial Statements in registration statements and proxy statements as exists under Rule 3-05.<sup>138</sup> When the Commission adopted the current filing period for Rule 3-05 in 1996,<sup>139</sup> it noted that commenters supported modification of Rule 3-14 as well, but deferred any changes to the rule. As with the other conforming amendments to Rule 3-14, we see no reason to provide a different regulatory treatment for acquisitions of real estate operations in this regard.

*Omission of Rule 3-14 Financial Statements for Real Estate Operations That Have Been Included in the Registrant's Financial Statements.* We propose to align the application of Rule 3-14 with the proposed amendments to Rule 3-05 by no longer requiring 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.<sup>140</sup> As with the other conforming amendments to Rule 3-14, we see no reason to provide a different regulatory treatment for acquisitions of real estate operations in this regard.

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<sup>137</sup> See *Reporting Requirements for Issuer's Change of Fiscal Year; Financial Reporting Changes; Period to be Covered by First Quarterly Report After Effective Date of Initial Registration Statement*, Release No. 33-6823 (Mar. 2, 1989) [54 FR 10306 (Mar. 13, 1989)].

<sup>138</sup> See discussion of the Rule 3-05 filing period in Section I.A. above.

<sup>139</sup> See *supra* note 13.

<sup>140</sup> See proposed Rule 3-14(b)(3)(iii).

*Additional Amendments.* We are also proposing other, less significant changes to align Rule 3-14 with Rule 3-05 where there are no unique industry considerations that suggest a business subject to Rule 3-14 should be treated differently than a business subject to Rule 3-05. We do not expect these proposed changes to affect how Rule 3-14 is applied in the following areas because existing practice already analogizes to Rule 3-05 for guidance. Specifically, we propose to clarify that:

- To be acquired real estate operations should be evaluated under the rule only if they are probable of acquisition;<sup>141</sup>
- The acquisition of an interest in a real estate operation accounted for using the equity method<sup>142</sup> or, in lieu of the equity method, the fair value option, should be considered the acquisition of a real estate operation;
- Rule 3-14 should not apply to a real estate operation which is totally held by the registrant prior to consummation of the transaction;<sup>143</sup> and
- Where a real estate operation to be acquired is the subject of a proxy statement or registration statement on Forms S-4 or F-4, the financial statement periods to be presented are those specified by Rules 3-01 and 3-02 of Regulation S-X.<sup>144</sup>

Additionally, in regard to significance testing, we propose to clarify that:

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<sup>141</sup> Rule 3-14 currently uses the phrase “proposes to acquire” when discussing “to be acquired” real estate operations and does not explicitly limit the scope to acquisitions probable of acquisition. The Commission’s proposed amendment would codify the current practice of interpreting this phrase to mean “probable of acquisition.” See FRM, *supra* note 40, at Section 2310.1

<sup>142</sup> See FRM, *supra* note 40, at Section 2305.4.

<sup>143</sup> See proposed Rule 3-05(a)(4).

<sup>144</sup> See proposed Rule 3-05(b)(1).



- related real estate operations should be treated as a single acquisition for significance testing;<sup>145</sup> and
- pro forma amounts are permitted for significance testing in certain circumstances consistent with the application in Rule 3-05.<sup>146</sup>

We also propose to clarify that Rule 3-14 Financial Statements should be prepared and audited in accordance with Regulation S-X and that they should be for the period that the real estate operation has been in existence, if that period is shorter than the period explicitly required for the financial statements.<sup>147</sup> In addition, the proposed amendments would conform the requirements related to acquisitions of foreign real estate operations in Rule 3-14 to the analogous provision in Rule 3-05.<sup>148</sup>

Aside from the substance of the rules, the proposed amendments would also conform the organization and format of certain related rules and forms, as appropriate. For example, Item 8 of Form 10-K currently exempts registrants from complying with Rule 3-05 and Article 11, but does not mention Rule 3-14.<sup>149</sup> Instead, the exception exists in Rule 3-14 itself.<sup>150</sup> We propose to move this exception to Form 10-K for consistency. We also propose to conform the general

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<sup>145</sup> See proposed Rule 3-05(a)(3) and proposed Rule 3-14(a)(3). Real estate operations are considered related if they are under common control or management, the acquisition of one real estate operation is conditional on the acquisition of each other real estate operation, or each acquisition is conditioned on a single common event.

<sup>146</sup> See proposed Rules 3-05(b)(3) and 11-01(b)(3).

<sup>147</sup> See proposed Rules 3-05(a)(1), 3-05(b)(2), 3-14(a)(1), and 3-14(b)(2). See also, discussion at note 76 above.

<sup>148</sup> See proposed Rules 3-05(c) and 3-14(d).

<sup>149</sup> See Item 8(a) of Form 10-K.

<sup>150</sup> Rule 3-14(b).

format and wording of Rule 3-14 to Rule 3-05, as appropriate, for consistency and to make the rule easier to follow.<sup>151</sup>

We are also proposing to revise Form 8-K, as follows:

- clarify that Item 2.01 requires the disclosure of the acquisition or disposition of assets that constitute a significant real estate operation as defined in Rule 3-14;<sup>152</sup>
- address the filing requirements in Item 9.01(a) consistently for all business acquisitions, including real estate operations; and
- revise Item 2.01 Instruction 4 to reference Rule 3-14 to make clear that, as with Rule 3-05, the aggregate impact of acquisitions of real estate operations is not required to be reported unless these acquisitions are related real estate operations and significant in the aggregate.

### **Request for Comment**

40. We are proposing to align Rule 3-14 with Rule 3-05 where no unique industry considerations warrant differentiated requirements. Are the proposed significance thresholds appropriate for acquisitions of real estate operations? Are the other changes we have proposed to Rule 3-14 appropriate? Are there unique industry considerations that suggest we should not make certain of the proposed amendments? If so, what are

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<sup>151</sup> The proposed changes in Rule 3-14 to conform wording include the addition of a paragraph similar to 3-05(b)(1) about financial statements for certain proxy statements and registration statements on Forms S-4 and F-4 as well as the elimination of outdated industry-specific paragraphs (a)(2) and (a)(3), which specify certain disclosures for circumstances that seldom occur today.

<sup>152</sup> While Item 2.01 currently only requires that significant acquisitions and dispositions be reported if they are not in the ordinary course of business, registrants provide Item 2.01 disclosure for acquisitions of significant real estate operations regardless of whether the acquisition or disposition was in the ordinary course of business. *See* Note to FRM, *supra* note 40, at Section 2310.3. We propose to revise Item 2.01 to achieve this same reporting outcome, because we believe this information is generally material to investors.

those considerations and which amendments should we not make? In these instances, are there different amendments we should consider?

41. Would the proposed amendments to align Rule 3-14 with Rule 3-05 assist preparers in the application of Rule 3-14? Would such amendments provide investors with more consistent disclosure for acquisitions of all types of businesses?
42. Are there other areas that we should consider for further alignment?

## **2. Definition of Real Estate Operation**

Neither Regulation S-X nor any other Securities Act or Exchange Act rule provides a definition of a real estate operation or an explanation of what is meant by the reference to properties in Rule 3-14. Because the terms are open to interpretation, Commission staff has provided guidance as to the meaning of a real estate operation and regarding properties subject to the rule.<sup>153</sup> The Commission staff has interpreted, for purposes of Rule 3-14, a real estate operation to refer to properties that generate revenues solely through leasing,<sup>154</sup> but has not interpreted this definition to preclude a property that includes a limited amount of non-leasing revenues (like property management or other services related to the leasing) from being considered a real estate operation. Examples of such properties include office, apartment, and industrial buildings, as well as shopping centers and malls. A real estate operation excludes properties that generate revenues from operations other than leasing, such as nursing homes, hotels, motels, golf courses, auto dealerships, and equipment rental operations because these operations are more susceptible to variations in revenues and costs over shorter periods due to

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<sup>153</sup> See FRM, *supra* note 40, at Section 2305.1 “*Applicability of S-X 3-14*,” and Section 2305.2, “*Nature of Real Estate Operations*.”

<sup>154</sup> See FRM, *supra* note 40, at Section 2305.2 “*Nature of Real Estate Operations*.”

market and managerial factors. The Commission staff has additionally provided guidance that a real estate operation includes real properties that will be held directly by the registrant or through an equity interest in a pre-existing legal entity that holds the real property under lease and related debt.<sup>155</sup>

We are proposing to amend Rule 3-14 to define a real estate operation as “a business that generates substantially all of its revenues through the leasing of real property,” which is consistent with current practice described above.<sup>156</sup> We believe that adding this definition to Rule 3-14 would appropriately limit the application of Rule 3-14, reduce uncertainty regarding the meaning of the term, and serve to clarify the rule without changing the substance of how it is currently applied. In addition, this change would make clear that a real estate operation is a “business” as that term is used in Article 11. We therefore further propose to remove the unnecessary condition in Rule 11-01(a)(5) that clarifies that Article 11 applies to real estate operations.

### **Request for Comment**

43. We propose to define a real estate operation in Rule 3-14 as “a business that generates substantially all of its revenues through the leasing of real property.” Is the proposed definition and scope of the rule appropriate? Are there revisions we should consider to the definition to further clarify its meaning or alter the types of businesses to which it applies?

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<sup>155</sup> See FRM, *supra* note 40, at Section 2305.3 “*Investment in a Pre-Existing Legal Entity*.”

<sup>156</sup> See proposed Rule 3-14(a)(2). The proposed amendment uses the term “business (as set forth in §210.11-01(d))” in the definition of a real estate operation to address the fact that the acquisition of a real estate operation may be of an entity holding real property under lease or a direct interest in the real property.

### 3. Significance Tests

Due to the nature of a real estate operation, staff interpretations have sought to focus registrants on the Investment Test in Rule 1-02(w), adapted to compare the registrant's investment in the real estate operation, including any debt secured by the real properties that is assumed by the registrant, to the registrant's total assets at the last audited fiscal year end filed with the Commission when determining "significance" under Rule 3-14.<sup>157</sup> When determining whether an acquisition is "significant," the use of the Asset or Income Tests generally is not practical for a real estate operation, because the historical amounts of assets and income of the acquired or to be acquired real estate operation are not available.<sup>158</sup>

We propose to amend Rule 3-14 to specify the use of a modified investment test, which is consistent with current practice described above.<sup>159</sup> As with the definition of a real estate operation, we believe this proposed amendment would reduce uncertainty regarding the significance tests and clarify the rule without changing the substance of how it is currently applied. We also believe that a modified investment test is necessary to appropriately determine significance for acquisitions of real estate operations because it considers the unique structure of these types of acquisitions, which typically involve assumed debt that is secured by the real properties that offsets the value of the real estate operation being acquired.

#### Request for Comment

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<sup>157</sup> See FRM, *supra* note 40, at Section 2315 "Real Estate Operations - Measuring Significance."

<sup>158</sup> The amounts are not available, because most real estate managers do not maintain their books on a U.S. GAAP basis or obtain audits. Furthermore, because Rule 3-14 only requires abbreviated income statements to be filed, additional financial statements would have to be prepared solely for purposes of significance testing if the Asset and Income Tests applied to acquisitions of real estate operations. See *supra* note 124 and accompanying discussion.

<sup>159</sup> See proposed Rule 3-14(b)(2).

44. We propose to amend Rule 3-14 to quantify the applicable significance thresholds and specify the use of a modified investment test in applying those thresholds for real estate operations. Are the proposed revisions to clarify the applicable significance tests and thresholds appropriate for acquisitions of real estate operations? Are there any unique industry considerations that suggest we should use different tests of significance than we have proposed?

#### **4. Interim Financial Statements**

Unlike Rule 3-05,<sup>160</sup> Rule 3-14 does not include an express requirement for registrants to provide interim financial statements. Article 11, however, requires pro forma financial information to be filed when the registrant has acquired one or more real estate operations which in the aggregate are significant.<sup>161</sup> Article 11 further provides that the pro forma condensed statement of comprehensive income shall be filed for the most recent fiscal year and the period from the most recent fiscal year to the most recent interim date for which a balance sheet is required.<sup>162</sup>

We propose to amend Rule 3-14 to specifically require Rule 3-14 Financial Statements for the most recent year-to-date interim period prior to the acquisition.<sup>163</sup> We believe requiring these financial statements, in addition to the annual financial statements, would enhance an investor's ability to understand the historical operating results of the acquisition without creating

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<sup>160</sup> See Rule 3-05(b)(2)(i) – (iv). The rule refers explicitly to the most recent fiscal year and any interim periods specified in Section 210.3-01 and 210.3-02.

<sup>161</sup> 17 CFR 210.11-01.

<sup>162</sup> 17 CFR 210.11-02(c)(2)(i). To meet this pro forma requirement, registrants must prepare and present substantially the same information for the most recent interim period, if applicable, that would be included in Rule 3-14 Financial Statements in most circumstances.

<sup>163</sup> See proposed Rule 3-14(b)(2)(i).

significant additional burden. It would also reflect existing registrant practice regarding the provision of interim financial statements to investors, which stems from Article 11 and related staff interpretation.<sup>164</sup>

### **Request for Comment**

45. We propose to amend Rule 3-14 to specifically require historical financial statements for the most recent interim period prior to the acquisition. Are the proposed revisions appropriate for acquisitions of real estate operations? Are there any unique industry considerations that suggest we should consider alternatives to the inclusion of financial statements for the most recent interim period prior to the acquisition for real estate operations?

### **5. Smaller Reporting Companies and Issuers Relying on Regulation A**

We propose amendments to Article 8 to further simplify and conform the application of Rule 3-14 and our related proposals to smaller reporting companies. Rule 8-06 provides smaller reporting company disclosure requirements for the financial statements of real estate operations acquired or to be acquired that are substantially similar to the requirements in Rule 3-14. Part F/S of Form 1-A directs an entity relying on Regulation A to present financial statements of real estate operations acquired or to be acquired as specified by Rule 8-06.<sup>165</sup> In order to simplify the application of our rules, we propose to revise Rule 8-06 to direct registrants to proposed Rule 3-14 for the requirements relating to financial statement disclosures of real estate operations acquired or to be acquired, while still permitting smaller reporting companies to rely on the form

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<sup>164</sup> See Rule 11-02(c)(2)(i) and FRM, *supra* note 40, at Section 2330.2 “*Periods to be Presented – Properties Acquired from Related Parties*” and Section 2330.3 “*Periods to be Presented – Properties Acquired from Third Parties.*”

<sup>165</sup> See paragraph (b)(7)(v) of Part F/S. Part F/S of Form 1-A permits the periods presented to be those applicable to Regulation A issuers rather than the periods specified by Article 8.

and content for annual and interim financial statements provided in Rules 8-02 and 8-03.<sup>166</sup>

Additionally, because Part F/S of Form 1-A refers to Rule 8-06, the proposed revisions to Rule 8-06 would apply to issuers relying on Regulation A.

We believe that simplifying these rules and using the more well-established practice and guidance applicable to Rule 3-14 would reduce burdens for smaller reporting companies and issuers relying on Regulation A.

### **Request for Comment**

46. Would the proposed revisions to Rule 8-06 to direct smaller reporting companies to Rule 3-14 while still permitting them to rely on the relief in Rules 8-02 and 8-03 simplify the application of our rules and reduce costs for registrants? Would the proposed revisions improve the disclosure available to investors by focusing registrants on the more detailed and better understood provisions of Rule 3-14? Are there other changes to the Rule 8-06 requirements that we should consider?
47. Should the proposed changes to Rule 8-06 apply to offerings made pursuant to Regulation A? Should we revise the proposals to better accommodate Regulation A issuers and investors? If so, what revisions should we make and why?

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<sup>166</sup> Under proposed Rule 8-06, there would be one change to the smaller reporting requirements for acquired real estate operations, namely that when financial statements are presented in Form S-11, the discussion of material factors that the registrant considered in assessing the acquisition shall be combined with the disclosure required by Item 15 of Form S-11. *See* the proposed Instruction to Paragraph (f) in proposed Rule 3-14. Since Item 15 of Form S-11 already applies to smaller reporting companies, the proposed Instruction would potentially change only the location of the discussion. We do not believe that it would require any new disclosure or add a burden to registrants. We additionally propose to add a reference to Rule 8-06 in Rule 3-06 to conform the requirements of proposed Rule 8-06 and proposed Rule 3-14 and to add a Note to Article 8 to expressly permit smaller reporting companies to file financial statements covering a period of nine to 12 months to satisfy the requirement for filing financial statements for a period of one year for an acquired real estate operation. *See* proposed Note 6 to Article 8 and the discussion related to Rule 3-06 in Section II.C.1 above.



## 6. Blind Pool Real Estate Offerings

Certain registrants<sup>167</sup> conducting continuous offerings over an extended period of time follow the guidance provided under Industry Guide 5 *Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships* (“Industry Guide 5”).<sup>168</sup> These registrants generally do not initially own any real estate assets, and the specific intended use of the proceeds raised from investors is not initially identified because such registrants have not yet selected any assets for their portfolios. Registrants in these “blind pool” offerings also typically provide only limited liquidity through restricted share redemption programs. However, these registrants provide certain undertakings<sup>169</sup> to disclose information about significant acquisitions to investors in addition to Rule 3-14 Financial Statements. Due to the nature of a blind pool investment as well as the supplemental undertakings provided, Commission staff has advised these registrants to apply adapted significance tests when making the determination of whether they are required to provide Rule 3-14 Financial Statements. Specifically, the staff has

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<sup>167</sup> These registrants are typically real estate investment trusts (“REITs”) that do not have securities listed for trading on a national securities exchange and often are referred to as “non-traded REITs.” Their purpose is to own and operate income-producing real estate or real estate-related assets.

<sup>168</sup> Industry Guide 5 was originally published as Securities Act Guide 60 in 1976 to provide disclosure guidance for preparing registration statements relating to offers and sales of interests in real estate limited partnerships. The Commission stated that the guide “is not a Commission rule nor is it published as bearing the Commission’s official approval.” See *Guide for Preparation of Registration Statements Relating to Interests In Real Estate Limited Partnerships*, Release No. 33-5692 (Mar. 17, 1976) [41 FR 17403 (Apr. 26, 1976)] (“Guide 60 Release”). In 1982, Securities Act Guide 60 was redesignated as Securities Act Industry Guide 5. See *Rescission of Guides and Redesignation of Industry Guides*, Release No. 33-6384 (Mar. 16, 1982) [47 FR 11476 (Mar. 16, 1982)], *Publication of Revisions to the Division of Corporation Finance’s Guide 5 and Amendment of Related Disclosure Provisions*, Release No. 33-6405 (June 3, 1982) [47 FR 25120 (June 10, 1982)]. While Industry Guide 5, by its terms, applies only to real estate limited partnerships, in 1991 the Commission stated that “the requirements contained in the Guide should be considered, as appropriate, in the preparation of registration statements for real estate investment trusts and for all other limited partnership offerings.” See *Limited Partnership Reorganizations and Public Offerings of Limited Partnership Interests*, Release No. 33-6900 (June 25, 1991) [56 FR 28979 (June 25, 1991)].

<sup>169</sup> See Item 20.D. of Industry Guide 5, Disclosure Guidance: Topic No. 6 – *Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts* and FRM, *supra* note 40, at Section 2325.2. “‘Blind Pool’ Offerings – During the Distribution Period - Undertakings.” The undertakings include use of sticker supplements related to certain significant properties that will be acquired and post-effective amendments.

interpreted significance during the distribution period to be computed by comparing the registrant's investment in the real estate operation to the sum of: (1) the registrant's total assets as of the date of the acquisition, and (2) the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months.<sup>170</sup> After the distribution period has ended, the staff has understood the registrant to be able to determine significance using the total assets as of the acquisition date until the registrant files its next Form 10-K. After that next Form 10-K is filed, the registrant, following the staff's guidance, can determine significance using total assets as of the end of the most recently completed fiscal year included in the Form 10-K.<sup>171</sup>

We propose to codify staff interpretation in this area by revising Rule 3-14 to add Rule 3-14(b)(2)(iii) to provide that significance for blind pool offerings shall be computed as described above. Similar to proposed Rule 3-05, we are also proposing to permit the determination of significance for acquisitions of real estate operations in blind pool offerings to be made using pro forma total assets as of the end of the most recently completed fiscal year included in the Form 10-K.<sup>172</sup> Otherwise, virtually all acquisitions in the early part of the distribution period would be deemed significant regardless of their size. Additionally, because blind pool investors are generally not able to freely sell their investments, basing the significance analysis only on total assets while the distribution is continuing is less useful to investors because the registrant is still growing its portfolio at this stage.

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<sup>170</sup> See FRM, *supra* note 40, at Section 2325.3 “*Blind Pool’ Offerings – During the Distribution Period – Significance.*” Calculation of the investment includes any debt secured by the real properties that is assumed by the purchaser. In addition, in estimating the offering proceeds, the registrant, following the staff's guidance, could consider the pace of fundraising as of the measurement date, the sponsor or dealer-manager's prior public fundraising experience, and offerings by similar companies.

<sup>171</sup> See FRM, *supra* note 40, at Section 2325.5 “*Blind Pool’ Offerings – After the Distribution Period.*”

<sup>172</sup> See proposed Rules 11-01(b)(3)(i) and 11-01(b)(3)(ii).

## **Request for Comment**

48. Are the amendments we propose for blind pool offerings appropriate? Are there changes to the requirements that we should consider?
49. Is the scope of proposed Rule 3-14(b)(2)(iii) sufficiently clear?
50. In certain circumstances, registrants in blind pool offerings acquire businesses that are within the scope of Rule 3-05 (for example, hotels) rather than Rule 3-14, but the registrants provide the Industry Guide 5 undertakings because they are conducting a blind pool offering. Currently, there is no special practice for measuring significance of Rule 3-05 acquisitions in these circumstances. Should we also consider applying the adapted significance tests described above for acquisitions of real estate operations in blind pool offerings to Rule 3-05 acquisitions in these circumstances? For example, as described in further detail above, should we permit adding the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months to the total assets of the registrant in computing the Investment and Asset Tests and permit registrants to exclude the Income Test from their significance determinations for part of the distribution period? Are there other modifications we should consider?

### **7. Triple Net Leases**

In some circumstances, registrants acquire a real estate operation subject to a triple net lease with a single lessee. A triple net lease typically requires the lessee to pay costs normally associated with ownership of the property, such as property taxes, insurance, utilities, and maintenance costs. Based on these attributes, the arrangement is similar to a financing for the lessee. The Rule 3-14 Financial Statements for a real estate operation subject to a triple net lease will ordinarily consist only of lease revenues. Under existing practice, registrants often provide

full audited financial statements of the lessee or guarantor of the lease, instead of the Rule 3-14 Financial Statements of the real estate operation, when the lessee is considered significant. Our proposal does not differentiate this type of acquisition or specify alternative requirements, because the activity depicted in the Rule 3-14 Financial Statements is consistent with how the triple net lease arrangement may affect the registrant's results of operations.<sup>173</sup> We believe financial statements of the acquired real estate operation more appropriately achieve Rule 3-14's objective to provide investors with information about how the acquired business may affect the registrant.

### **Request for Comment**

51. Should we consider different financial statement requirements in Rule 3-14 for circumstances where a registrant acquires a real estate operation subject to a triple net lease with a single lessee where the lessee is significant to the registrant (for example, full audited financial statements of the lessee or guarantor of the lease)? If not, are there additional disclosures (for example, summarized unaudited financial information) we should require about the lessee or guarantor of the lease in addition to the Rule 3-14 Financial Statements?

#### **D. Pro Forma Financial Information**

The pro forma financial information described in Article 11 of Regulation S-X must accompany Rule 3-05 Financial Statements and Rule 3-14 Financial Statements. Typically, pro forma financial information includes the most recent balance sheet and most recent annual and interim period income statements. Pro forma financial information for a business acquisition

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<sup>173</sup> The proposal diverges from staff interpretation with respect to time-of-acquisition reporting, which has indicated that when a real estate operation subject to a triple net lease represents a significant portion of the registrant's total assets, an investor may need to consider the lessee's financial statements in order to evaluate the risk to the registrant from the asset concentration. See FRM, *supra* note 40, at Section 2340.

combines the historical financial statements of the registrant and the acquired business and is adjusted for certain items if specified criteria are met. As discussed above, pro forma financial information for an acquired business is required at the 20% and 10% significance thresholds under Rule 3-05 and Rule 3-14, respectively.<sup>174</sup> The rules also require pro forma financial information for a significant disposed business at a 10% significance threshold for all registrants.

### **1. Adjustment Criteria and Presentation Requirements**

Rule 11-02 contains rules and instructions for the presentation of pro forma financial information. The rules provide some flexibility to tailor pro forma disclosures to particular events and circumstances. The presentation requirements for the pro forma condensed statement of comprehensive income were designed to elicit disclosures that distinguish between the one-time impact and the on-going impact of a transaction.<sup>175</sup> The rules call for the pro forma financial information to show the impact of the transaction on income from continuing operations of the registrant.<sup>176</sup>

Article 11 provides that the only adjustments that are appropriate in the presentation of the pro forma condensed statement of comprehensive income are those that are:

- directly attributable to the transaction,
- expected to have a continuing impact on the registrant, and

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<sup>174</sup> See 1996 Streamlining Release, *supra* note 13.

<sup>175</sup> See *Instructions for the Presentation and Preparation of Pro Forma Financial Information and Requirements for Financial Statements of Businesses Acquired or To Be Acquired*, Release No. 33-6413 (June 24, 1982) [47 FR 29832 (July 9, 1982)] indicating that “[t]he presentation requirements for the pro forma condensed statement of income are designed to elicit disclosures that clearly distinguish between the one-time impact and the on-going impact of the transaction and thereby assist investors in focusing on the transaction at hand.”

<sup>176</sup> Discontinued operations would not be reflected in the condensed historical financial statements used as the starting point for the pro forma presentation.

- factually supportable.<sup>177</sup>

The pro forma condensed balance sheet, on the other hand, reflects pro forma adjustments that are directly attributable to the transaction and factually supportable, regardless of whether the impact is expected to be continuing or nonrecurring because the objective of the pro forma balance sheet is to reflect the impact of the transaction on the financial position of the registrant as of the balance sheet date.

We propose to revise Article 11 by replacing the existing pro forma adjustment criteria with simplified requirements to depict the accounting for the transaction and present the reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur.<sup>178</sup> We are proposing to replace the existing pro forma adjustment criteria because they are not clearly defined nor easily applied and, in practice, can yield inconsistent presentations for similar fact patterns. The existing adjustments also preclude the inclusion of adjustments for the potential effects of post-acquisition actions expected to be taken by

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<sup>177</sup> See 17 CFR 210.11-02(b)(6). Material non-recurring charges or credits which result directly from the transaction and which will impact the income statement during the next 12 months are not reflected in the pro forma condensed statement of comprehensive income.

<sup>178</sup> We propose several other changes to simplify and clarify Article 11 and to provide more consistent use of terminology. For example, we propose to make changes throughout Article 11 to refer to “pro forma financial information,” “potential common stock” as defined in U.S. GAAP, and “pro forma basic” per share data. In a further effort to simplify and clarify, we propose deleting Rule 11-02(a), which describes the objectives of the preparation requirements, to avoid confusion and focus registrants on the requirements of the rule. We propose amending Rule 11-01(a)(8) to remove the reference to other “events” as we believe the concept of other events is encompassed by the reference to “other transactions.” We also propose amending Rule 11-02(b)(2), which relates to the introductory paragraph, to refer to “each transaction for which pro forma effect is being given” rather than “the transaction” in recognition that the information may be required to give effect to more than one transaction. See proposed Rule 11-02(a)(2). Additionally, we propose revising Rule 11-02(b)(5) to require the pro forma condensed statement of comprehensive income to also disclose income (loss) from continuing operations attributable to the controlling interests, in addition to income (loss) from continuing operations, because that is the amount currently used to calculate earnings per share under U.S. GAAP. See proposed Rule 11-02(a)(5).

management, which can be important to investors. Commenters generally recommended allowing more flexibility with respect to the types of pro forma adjustments allowed.<sup>179</sup>

The proposed adjustments would be broken out into two categories:

- (i) “Transaction Accounting Adjustments”; and
- (ii) “Management’s Adjustments.”<sup>180</sup>

Transaction Accounting Adjustments would depict: (1) in the pro forma condensed balance sheet the accounting for the transaction required by U.S. GAAP or IFRS-IASB,<sup>181</sup> and (2) in the pro forma condensed income statements, the effects of those pro forma balance sheet adjustments assuming the adjustments were made as of the beginning of the fiscal year presented.<sup>182</sup> The Transaction Accounting Adjustments are intended to reflect only the application of required accounting to the acquisition, disposition, or other transaction. We

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<sup>179</sup> See, e.g., letters from ABA-Committees, CalPERS, CAQ, Comcast Corporation (Dec. 11, 2015), DT, EEI/AGA, EY, and Grant. One commenter noted, among other points, that the pro forma financial statements would be much more relevant if they allowed for more forward-looking information and articulation of management’s expectations to be incorporated. See letter from CFA.

<sup>180</sup> Under these proposed revisions to Article 11, some of the current guidance and instructions would no longer apply. We propose to eliminate the instructions and incorporate the substance of the relevant instructions into other provisions, particularly proposed Rule 11-02(b) Implementation Guidance. We propose to eliminate the substance of the first sentence of Instruction 2 as well as Instruction 4 and Instruction 5 of Rule 11-02(b) as this guidance would be superseded by the requirements for Transaction Accounting Adjustments and Management’s Adjustments. Similarly, Instruction 3 regarding business dispositions would no longer be necessary given the guidance in proposed Rules 11-02(a)(4), 11-02(a)(6), and 11-02(b)(3). We propose to incorporate, subject to revisions to update terminology and clarify language, the substance of Instruction 1, using income from continuing operations, into proposed Rule 11-02(b)(1) and Instruction 2 guidance on financial institutions into proposed Rule 11-02(b)(2). We propose to add new Rule 11-02(b)(4) in place of Instruction 6 to clarify that each transaction for which pro forma effect is required to be given shall be presented in separate columns. We also propose to add new Rule 11-02(b)(5) to replace Instruction 7 to Rule 11-02(b) which would incorporate pro forma tax effect guidance from Staff Accounting Bulletin No. 1.B., *Allocation Of Expenses And Related Disclosure In Financial Statements Of Subsidiaries, Divisions Or Lesser Business Components Of Another Entity, 1. Costs reflected in historical financial statements.*

<sup>181</sup> If the condition in Rule 11-01(a) that is met does not have a balance sheet effect, then our proposal would require that Transaction Accounting Adjustments depict the accounting for the transaction required by U.S. GAAP or, if applicable, IFRS-IASB. Transaction Accounting Adjustments would be limited to adjustments to account for the transaction using the measurement date and method prescribed by the applicable accounting standard. For probable transactions, the measurement date would be as of the most recent practicable date prior to the effective date (for registration statements) or the mailing date (for proxy statements).

<sup>182</sup> See proposed Rule 11-02(a)(6)(i)(B).

believe the Transaction Accounting Adjustments would link the effects of the acquired business to the registrant's audited historical financial statements while the Management's Adjustments would provide flexibility to include forward-looking information that depicts the synergies and other transaction effects identified by management in determining to consummate or integrate the transaction for which pro forma effect is being given.

Management's Adjustments would be required for and limited to synergies and other effects of the transaction, such as closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements, that are both reasonably estimable and have occurred or are reasonably expected to occur.<sup>183</sup> We believe it is appropriate to require disclosure of synergies and other transaction effects in these circumstances in order to provide investors insight into the potential effects of the acquisition and the post-acquisition plans expected to be taken by management. Limiting Management's Adjustments to those that are reasonably estimable and that have occurred or are reasonably expected to occur will serve to define the population of effects subject to inclusion in pro forma financial information. While not all information is appropriate for reflecting an adjustment in the pro forma financial information, some information where the synergies and other transaction effects are not reasonably estimable would still be important to investors. We believe that any information necessary to give a fair and balanced presentation of the pro forma financial information should

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<sup>183</sup> See proposed Rule 11-02(a)(6)(ii). However, if the registrant previously was a part of another entity and presentation of pro forma financial information is necessary to reflect operations and financial position of the registrant as an autonomous entity, the proposed rules would provide that the adjustments necessary to show the registrant as an autonomous entity be included in Management's Adjustments. See proposed Rules 11-01(a)(7) and 11-02(a)(6)(ii)(B). For example, where a company (the registrant) operates as a subsidiary of another entity and files a registration statement under the Securities Act of 1933 in connection with an initial public offering, and presentation of pro forma financial information is necessary to reflect the operations and financial position of the registrant as an autonomous entity, the registration statement would include Article 11 pro forma financial information, which under our proposal would include such adjustments in Management's Adjustments.



be provided to investors. Thus, we propose to require registrants to additionally provide qualitative disclosure of such information in the explanatory notes to the pro forma financial information to further elicit appropriately balanced disclosure.

We also propose to include presentation requirements for Management's Adjustments. The presentation requirements would provide that Management's Adjustments be presented through a separate column in the pro forma financial information after the presentation of the combined historical statements and Transaction Accounting Adjustments.<sup>184</sup> This presentation would permit investors to distinguish the accounting effects on the registrant of the underlying acquired business from operational effects of management's plans that are subject to management's discretion or other uncertainties. Similarly, we propose that per share data be presented in two separate columns. One column would present the pro forma total depicting the combined historical statements with only the Transaction Accounting Adjustments, and the second column would present the combined historical statements with both the Transaction Accounting Adjustments and Management's Adjustments.

To clarify the required disclosure in the explanatory notes accompanying the pro forma financial information, we propose to add requirements based on existing rules, practice, and staff interpretation that would require disclosure of:

- revenues, expenses, gains and losses, and related tax effects which will not recur in the income of the registrant beyond 12 months after the transaction;<sup>185</sup>

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<sup>184</sup> Management's Adjustments might contain forward-looking information. To the extent Management's Adjustments contain forward-looking information, the safe harbor provisions under 17 CFR 230.175 and 17 CFR 240.3b-6 would be available for the disclosures. We propose clarifying the availability of the safe harbor within Article 11. See the Instruction to proposed Rule 11-02(a)(6)(ii).

<sup>185</sup> See proposed Rule 11-02(a)(10)(i). See also current Rule 11-02(b)(5).

- total consideration transferred or received, including its components and how they were measured. If total consideration includes contingent consideration, the proposed amendments would require disclosure of the arrangement(s), the basis for determining the amount of payment(s) or receipt(s), and an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why; and
- information about Transaction Accounting Adjustments when the initial accounting is incomplete.<sup>186</sup>

For each Management’s Adjustment, we propose to require:

- a description, including the material uncertainties, of the synergy or other transaction effects;
- disclosure of the underlying material assumptions, the method of calculation, and the estimated time frame for completion;
- qualitative information necessary to give a fair and balanced presentation of the pro forma financial information; and
- to the extent known, the reportable segments, products, services, and processes involved; the material resources required, if any; and the anticipated timing.<sup>187</sup>

We believe these disclosures are necessary for an investor to be able to understand the Management’s Adjustments. For synergies and other transaction effects that are not reasonably estimable and will not be included in Management’s Adjustments, we additionally propose to

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<sup>186</sup> See proposed Rule 11-02(a)(10)(ii). See also FRM, *supra* note 40, at Section 3250 1.f., 3250 1.g., and 3250 1.h.

<sup>187</sup> See proposed Rule 11-02(a)(10)(iii).

require that qualitative information necessary for a fair and balanced presentation of the pro forma financial information also be provided.<sup>188</sup>

We additionally propose to clarify that pro forma financial information must be appropriately labeled and presented as required by Article 11.<sup>189</sup> We also propose to require that each transaction for which pro forma effect is required to be given shall be presented in a separate column.<sup>190</sup> Finally, we propose to require that if pro forma financial information includes another entity's statement of comprehensive income, such as that of an acquired business, it shall be brought up to within one fiscal quarter, if practicable.<sup>191</sup> This change will better accommodate registrants and acquired businesses that have 52-53 week fiscal years than the current requirement to bring the financial information to within 93 days of the registrant's most recent fiscal year end, if practicable.

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52. Are the proposed amendments to the pro forma financial information requirements appropriate? Is our Transaction Accounting Adjustments proposal sufficiently clear? Will our Transaction Accounting Adjustment proposal simplify preparation of pro forma financial information and improve consistency?
53. The proposed Transaction Accounting Adjustments would incorporate the accounting required by U.S. GAAP or IFRS-IASB. However, there remain areas where the pro

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<sup>188</sup> See proposed Rule 11-02(a)(10)(iv).

<sup>189</sup> See proposed Rule 11-02(a)(11) and 11-02(c)(2). We propose to explicitly require this labeling and presentation in Article 11 to avoid confusing or inconsistent disclosure. The proposed rules would also generally preclude presentation of pro forma financial information on the face of the historical financial statements, except where such presentation is specifically required by U.S. GAAP or IFRS-IASB, presentation of summaries of pro forma financial information that exclude material transactions, or presentations that give pro forma effect to the adoption of accounting standards.

<sup>190</sup> See proposed Rule 11-02(b)(4).

<sup>191</sup> See proposed Rule 11-02(c)(3).

forma disclosure requirements in the proposed amendments and U.S. GAAP are not the same. Is this likely to cause confusion among investors? If so, what could be done to remedy the confusion?

54. Are the criteria for determining when Management's Adjustments are required sufficiently clear? Are there other criteria we should consider?
55. Should we instead retain the existing pro forma adjustment criteria? Why or why not? If we retained the existing criteria, would they be operational if we deleted the existing "continuing impact" criterion? If we retained the existing criteria, would pro forma presentations be improved by eliminating the continuing impact adjustment criterion and replacing this criterion with a revised requirement to disclose revenues, expenses, gains and losses, and related tax effects which will not recur in the income of the registrant beyond 12 months after the transaction in the explanatory notes to the pro forma financial statements? For example, would that resolve diversity in practice related to adjustments to items like deferred revenue, costs of goods sold, and interest expense for short-term bridge financings that may be refinanced?
56. Under the proposed amendments, Management's Adjustments must be reasonably estimable and have occurred or be reasonably expected to occur. Do these conditions adequately serve to distinguish which Management's Adjustments can be made? Are they appropriate? Why or why not?
57. Are the proposed Management's Adjustments appropriate? What other conditions, if any, should we consider establishing? For example, should we limit Management's Adjustments to synergies and other transaction effects that have previously been furnished or filed in disclosure with the Commission? If we limited Management's

Adjustments in this way, how would we ensure that the adjustments are balanced to include both the positive and negative effects?

58. To the extent that Management's Adjustments require forward-looking information, what safe harbors should apply? As proposed, Securities Act Rule 175 and Exchange Act Rule 3b-6 would expressly apply. Are there different protections that would be appropriate?
59. Is the proposed amendment to require that pro forma financial information be brought up to within one fiscal quarter if the pro forma financial information includes another entity's statement of comprehensive income appropriate? Is there another more appropriate time frame we should consider?
60. Will the proposed disclosures in the explanatory notes provide material information for investors? Are the proposed requirements for the format and presentation of pro forma information appropriate? Are there other amendments we should consider to improve the presentation requirements of Article 11?
61. Rule 11-01(a)(8) requires presentation of pro forma financial information when, "[c]onsummation of other events or transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors." We propose to delete the reference to "events." Is deletion of the reference to "events" appropriate? Would its deletion unintentionally narrow the population of items for which pro forma financial information must be provided? If so, what items would not be captured, what term appropriately describes those items for which pro forma effect should be given, and why is it a better descriptor than "transactions?" If "events" is retained, should the term be included in other parts of our proposal? Why or why not?

62. Should we further clarify that under the proposed amendments Management's Adjustments are only permitted when they relate to the transaction for which pro forma effect is being given? If so, what changes should we consider?
63. Proposed Rule 11-02(b)(3) retains the existing guidance in current Rule 11-02(b)(3) for condensing information on the face of the pro forma financial statements. This guidance differs from the guidance in Rules 10-01(a)(2) and 10-01(a)(3) for preparing the registrant's interim financial statements. Should we conform proposed Rule 11-02(b)(3) to Rules 10-01(a)(2) and 10-01(a)(3)? Why or why not? If so, should we limit the changes to selected parts of Rules 10-01(a)(2) and (a)(3), such as the percentage thresholds?

## **2. Significance and Business Dispositions**

Rule 11-01(a)(4) provides that pro forma financial information is required upon the disposition or probable disposition of a significant portion of a business either by sale, abandonment, or distribution to shareholders by means of a spin-off, split-up, or split-off, if that disposition is not fully reflected in the financial statements of the registrant. Rule 11-01(b) further provides that a disposition of a business is significant if the business to be disposed of meets the conditions of a significant subsidiary under Rule 1-02(w). Rule 1-02(w) uses a 10% significance threshold, not the 20% threshold used for business acquisitions under Rules 3-05 and 11-01(b). When a registrant determines that it has an acquisition or disposition of a significant amount of assets that do not constitute a business, Item 2.01 of Form 8-K uses a 10% threshold for both acquisitions and dispositions to require disclosure of certain details of the

transaction.<sup>192</sup> The terms “business” and “significant” used in Form 8-K specifically reference Article 11 of Regulation S-X.

We propose revising Rule 11-01(b) to raise the significance threshold for the disposition of a business from 10% to 20%, to conform to the threshold at which an acquired business is significant under Rule 3-05.<sup>193</sup> We also propose conforming, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine significance of an acquired business.<sup>194</sup> This change would be consistent with the symmetrical treatment in Form 8-K provided to acquisitions and dispositions of assets that do not constitute a business.<sup>195</sup> Finally, we propose revising Form 8-K and Article 8 to require smaller reporting companies to provide pro forma financial information for disposition of a significant business in Form 8-K and in certain registration statements and proxy statements when the disposition occurs during or after the most recently completed fiscal year.<sup>196</sup>

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<sup>192</sup> For acquisitions and dispositions of assets that do not constitute a business, Item 2.01 of Form 8-K specifies the tests to be used rather than referencing the tests in Rule 1-02(w). Specifically, Item 2.01 states that, “an acquisition or disposition shall be deemed to involve a significant amount of assets: (i) if the registrant’s and its other subsidiaries’ equity in the net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries; or (ii) if it involved a business (*see* 17 CFR 210.11-01(d)) that is significant (*see* 17 CFR 210.11-01(b)).”

<sup>193</sup> *See* proposed Rule 11-01(b). We propose to revise Rule 11-01(b) to clearly provide for business acquisitions and dispositions, indicating that registrants should look to the conditions of a significant subsidiary in Rule 1-02(w), but substitute a 20% threshold for the 10% threshold provided in Rule 1-02(w) for both acquisitions and dispositions of businesses. We also propose to substitute a 20% threshold for the current 10% threshold for real estate operations. *See* proposed Rule 3-14(b)(2) and the related discussions in Section II.C. above.

<sup>194</sup> *See* Section II.D.2. and proposed Rule 11-01(b)(2).

<sup>195</sup> *See supra* note 192.

<sup>196</sup> The Form 8-K requirement for smaller reporting companies to provide pro forma financial information cites to Rule 8-05. Rule 8-05, however, only applies to acquisitions. While Article 8 has a requirement in Rule 8-03(b)(4) to provide pro forma financial information about dispositions of significant businesses, the provision only applies to the registrant’s interim financial statements. In order to address the anomalous outcome where pro forma financial information is required when interim financial statements are presented but not when annual financial statements are presented, we propose to remove Rule 8-03(b)(4) and revise Rule 8-05 to require disclosure of pro forma financial information when any of the conditions in Rule 11-01 is met. *See* further discussion in Section II.D.3.

The proposed revisions would also apply to dispositions of real estate operations as defined in § 210.3-14(a)(2).<sup>197</sup> Unlike for acquisitions of real estate operations, the investment, asset, and income tests would apply. Where real estate operations have been included in the consolidated financial statements of the registrant, the information necessary to apply these tests would be available, and we are aware of no unique industry considerations that might warrant limiting the significance determination to only the investment test. However, similar to acquisitions of real estate operations, we propose that debt secured by the real properties that is assumed by the buyer would be included in the investment test when the “investment in” real estate operations is being compared to total assets of the registrant.<sup>198</sup>

We believe that having the same threshold and tests for the disposition of a business would simplify compliance for registrants. We further see no compelling reason why the subset of businesses for which investors need information should differ depending on whether the business is being acquired or disposed. The Commission previously raised the significance threshold for acquisitions to 20%,<sup>199</sup> and we received no comment in response to the 2015 Request for Comment suggesting that the higher significance threshold has created issues for investors regarding the sufficiency of information provided. Rather, a number of commenters recommended conforming the significance threshold to present pro forma financial information for a material disposition to the threshold for acquisitions.<sup>200</sup>

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<sup>197</sup> See proposed Rule 11-01(b)(2).

<sup>198</sup> See proposed Rule 1.02(w)(1)(i)(D).

<sup>199</sup> See 1996 Streamlining Release, *supra* note 13.

<sup>200</sup> See, e.g., *letters* from ABA, BDO, CAQ, EY, Grant, and KPMG.



64. Is our proposal to raise the significance threshold for the disposition of a business from 10% to 20% appropriate? Why or why not?
65. Is our proposal to conform the tests used to determine significance of a disposed business to those used to determine significance of an acquired business appropriate? Why or why not? Does the guidance in Instruction 4 of Item 2.01 of Form 8-K related to determining the significance of an asset acquisition or disposition that does not constitute a business (*see* Rule 11-01(d)) require clarification or adjustment? If so, what clarifications or adjustments are required and why?
66. Are there other changes that we should consider with respect to the financial information required for a disposed business that would reduce compliance burdens for issuers but continue to provide the material information investors need to make informed investment decisions?
67. Should the investment, asset, and income tests apply to real estate operations in determining the significance for dispositions as proposed? Why or why not? Should the significance determination be limited to the investment test? If so, why?
68. Should debt secured by the real properties that is assumed by the buyer be included in the investment test as proposed when the “investment in” a real estate operation is being compared to total assets of the registrant for purposes of measuring significance of a disposed real estate operation? Why or why not?

### **3. Smaller Reporting Companies and Issuers Relying on Regulation A**

Rule 8-05 sets forth pro forma financial information requirements for business acquisitions by smaller reporting companies. Additionally, Part F/S of Form 1-A directs an entity relying on Regulation A to present the pro forma financial information specified by Rule

8-05.<sup>201</sup> Like Article 11, Rule 8-05(a) requires pro forma financial information only if financial statements of a business acquired or to be acquired are presented. Like Article 11, Rule 8-05(b) provides that pro forma financial statements must consist of a pro forma balance sheet and a pro forma statement of comprehensive income presented in condensed, columnar form for the most recent year and interim period. Rule 8-05(b), however, does not provide further preparation guidance, such as the types of pro forma adjustments that can be made. Note 2 of the Preliminary Notes to Article 8 provides that, to the extent that Article 11-01 offers enhanced guidelines for the preparation, presentation, and disclosure of pro forma financial information, smaller reporting companies may wish to consider these items.

We are proposing to revise Rule 8-05 to require that the preparation, presentation, and disclosure of pro forma financial information by smaller reporting companies substantially comply with Article 11.<sup>202</sup> Additionally, because Part F/S of Form 1-A refers to Rule 8-05, the proposed revisions to Rule 8-05 would apply to issuers relying on Regulation A. We believe the primary differences between Rule 8-05 and Article 11 relate to the types of pro forma adjustments that can be made and the number of periods required to be depicted.<sup>203</sup> The

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<sup>201</sup> See paragraph (b)(7)(iv) of Part F/S. Part F/S of Form 1-A permits the periods presented to be those applicable to Regulation A issuers rather than the periods specified by Article 8.

<sup>202</sup> See proposed Rule 8-05(b). The one exception would relate to the requirement to present pro forma financial information in condensed format. Rule 8-05 requires presentation of pro forma financial information in condensed, columnar form, but does not define “condensed.” However, Rule 8-03(a) provides requirements for presenting interim financial statements of smaller reporting companies in condensed format. These requirements differ from the similar requirements in Rule 11-02(b)(3) for presenting “condensed” pro forma financial information under Article 11. Because pro forma financial information begins with the historical financial statements of the registrant, proposed Rule 8-05 would require application of Rule 8-03(a) requirements for condensed format rather than the requirement in Rule 11-02(b)(3).

<sup>203</sup> Article 11 requires presentation of pro forma financial information for all periods for which historical income statements of the registrant are required when the transaction for which pro forma effect is being given will be reflected in the registrant’s historical financial statements by retrospectively revising those financial statements for all periods presented. Rule 8-05 does not have a similar provision. One effect of conforming Rule 8-05 to Article 11 is that smaller reporting companies would have to provide pro forma financial information for two years in these circumstances. Because the circumstances requiring retrospective revision are generally within

proposed amendments would therefor provide the same benefits to smaller reporting companies and issuers relying on Regulation A with respect to pro forma financial information as would be available to other registrants under the proposed revisions to Article 11. For example, the proposed rules would permit smaller reporting companies and issuers relying on Regulation A to disclose Transaction Accounting Adjustments and Management's Adjustments on a basis consistent with other registrants.<sup>204</sup> These amendments would also provide investors with more uniform information upon which to make their investment decisions.

We are also proposing to revise Rule 8-05 to require presentation of pro forma financial information when the conditions in Rule 11-01 exist.<sup>205</sup> Because Rule 8-05 currently requires pro forma financial information only for business acquisitions,<sup>206</sup> conforming the conditions would require smaller reporting companies and issuers relying on Regulation A to provide pro forma financial information whenever it is material to investors, regardless of the nature of the underlying transactions.<sup>207</sup> Based on a staff analysis of 2017 disclosures of acquisitions and

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the registrant's control and the registrant must eventually revise its previously filed historical financial statements for all periods to reflect these circumstances, we do not believe our pro forma proposal will be a significant incremental burden to smaller reporting companies. We welcome commenters' views on whether our belief is correct.

<sup>204</sup> See Section II.D.1. We believe the proposed Transaction Accounting Adjustments, which would depict in the pro forma condensed balance sheet the accounting for the transaction required by U.S. GAAP or IFRS-IASB and the effects of those pro forma balance sheet adjustments, would benefit smaller reporting companies and their investors by simplifying preparation of the pro forma financial information. The proposed Management's Adjustments, which would require information that depicts reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur, would also benefit smaller reporting companies and their investors by eliciting more transaction related disclosure, including forward-looking information.

<sup>205</sup> See proposed Rule 8-05(a).

<sup>206</sup> See *supra* Section II.D.2.

<sup>207</sup> The incremental conditions that would require a smaller reporting company to present pro forma financial information under this proposal would include: roll-up transactions as defined in 17 CFR 229.901(c); when such presentation is necessary to reflect the operations and financial position of the smaller reporting company as an autonomous entity; and other transactions for which disclosure of pro forma financial information would be material to investors.

dispositions by smaller reporting companies, we believe that most already comply with the conditions in existing Rule 11-01.<sup>208</sup>

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69. Would the proposed revisions to Rule 8-05 to require Transaction Accounting Adjustments and Management's Adjustments simplify the application of our rules and reduce costs for registrants? Would the proposed revisions improve the disclosure available to investors without introducing significant incremental costs or burdens? Are there unique considerations that suggest smaller reporting companies should have different pro forma adjustment requirements? If so, what are those considerations, what different requirements should apply and why? Will the proposed Article 11 implementation guidance be beneficial to smaller reporting companies? Why or why not? Is there different implementation guidance that would be more beneficial? Are there other changes to the Rule 8-05 requirements that we should consider?
70. Our proposal to require pro forma financial information for disposition of a significant business in Form 8-K and in certain registration statements and proxy statements when the disposition occurs during or after the most recently completed fiscal year and to permit the use of pro forma financial information to determine significance in the context of business dispositions would also apply to smaller reporting companies based on our proposed revisions to Rule 8-05. Is requiring smaller reporting companies to provide pro forma information and permitting them to determine significance using pro forma financial information in the context of business dispositions appropriate? Are there other

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<sup>208</sup> Commission staff found that out of 191 disclosures of acquisitions and dispositions by smaller reporting companies in 2017, 178 appeared to comply with Article 11 requirements.

changes or information requirements we should consider for smaller reporting companies?

71. Is our proposal to require presentation of pro forma financial information when the conditions in Rule 11-01 exist, such that smaller reporting companies would be required to provide the information whenever it is material to investors, appropriate? If not, when should smaller reporting companies be required to provide pro forma financial information?

72. Should the proposed changes to Rule 8-05 apply to offerings made pursuant to Regulation A? If not, how should we revise the proposals to better accommodate Regulation A issuers and investors?

**E. Amendments to Financial Disclosure About Acquisitions Specific to Investment Companies**

For financial reporting purposes, investment company registrants, including business development companies, must apply the general provisions in Articles 1, 2, 3, and 4 of Regulation S-X,<sup>209</sup> unless subject to the special rules<sup>210</sup> set forth in 17 CFR 210.6-01 through 6-10 (“Article 6”). Investment company registrants differ from non-investment company registrants in several respects. Investment companies invest in securities principally for returns from capital appreciation and/or investment income. Investment companies are required to value<sup>211</sup> their portfolio investments, with changes in value recognized in the statement of

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<sup>209</sup> In October 2016, as part of a broader investment company reporting modernization rulemaking, the Commission adopted certain amendments to Regulation S-X that would expressly apply Article 6 to business development companies. *See Investment Company Reporting Modernization*, Release No. IC-32314 (Oct. 13, 2016) [81 FR 81870 (Nov. 18, 2016)].

<sup>210</sup> *See* 17 CFR 210.6-03.

<sup>211</sup> *See* 17 CFR 210.6-02(b) (“the term value shall have the same meaning given in Section 2(a)(41)(B) of the Investment Company Act”).

operations for each reporting period.<sup>212</sup> Also, investment companies generally do not consolidate entities they control and do not account for portfolio investments using the equity method.<sup>213</sup>

The proposed amendments are designed to tailor the financial reporting requirements for investment companies with respect to acquisitions of investment companies and other types of funds (collectively, “acquired funds”).<sup>214</sup> There are no specific rules or requirements in Article 6 for investment companies relating to the financial statements of acquired funds. Instead, investment companies apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11, although it is often unclear how to apply these reporting requirements in the context of acquired funds. As a result, investment company registrants frequently consult with Commission staff on the application of Rule 3-05 and Article 11 as part of the registration or filing process to seek relief from those requirements pursuant to Rule 3-13 and delegated authority,<sup>215</sup> a time-consuming process for both the registrant and the staff. Currently, investment companies typically file Rule 3-05 Financial Statements in transactions in which an investment company with limited assets and operating history is created for the purpose of acquiring one or more private funds operating under the exemptions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. This type of acquisition typically occurs early in the life of the acquiring investment company when it has few or no portfolio investment

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<sup>212</sup> See FASB ASC 946-320-35, FASB ASC 946-323, FASB ASC 946-325-35, FASB ASC 946-810, and FASB ASC 815-10-35.

<sup>213</sup> See FASB ASC 946-810-45-2 (general consolidation guidance) and FASB ASC 946-810-45-3 (the exception to that guidance when considering an investment in an operating company that provides services to the investment company).

<sup>214</sup> 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. See, e.g., Rule 11-01(d).

<sup>215</sup> See *supra* note 43. The Commission has delegated authority to the staff in the Division of Investment Management to grant requests for relief under Rule 3-13 with respect to investment companies.

assets of its own. In these cases, Rule 3-05 Financial Statements of the acquired fund or funds may be the primary financial information considered by investors when making investment decisions with respect to the investment company.

We are proposing to add a definition of significant subsidiary in Regulation S-X that is specifically tailored for investment companies based on the current Rule 8b-2 definition with some modifications.<sup>216</sup> Investment companies are required to use the significant subsidiary tests in Rule 1-02(w) when applying Rule 3-05 and other rules within Regulation S-X. However, the tests in Rule 1-02(w) were not written for the specific characteristics of investment companies.<sup>217</sup> Further, there is a different definition of significant subsidiary set forth in Rule 8b-2 that is applicable to the filing of registration statements and reports under the Investment Company Act,<sup>218</sup> which creates inconsistencies with the Regulation S-X definition.<sup>219</sup> Moreover, the rules promulgated pursuant to Section 8 of the Investment Company Act are not applicable to business development companies.<sup>220</sup> Commission staff has previously described its views as to how certain Regulation S-X provisions apply to business development companies in connection with

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<sup>216</sup> See proposed Rule 1-02(w)(2). We additionally propose to amend Rule 1-02(w) to provide that, with respect to the condition in proposed Rule 1-02(w)(2)(ii), the value of investments shall be determined in accordance with U.S. GAAP and, if applicable, Section 2(a)(41) of the Investment Company Act (15 U.S.C. 80a-2(a)(41)).

<sup>217</sup> For example, one condition of the significant subsidiary definition examines the investment company's "equity in the income from continuing operations before income taxes exclusive of amounts attributable to any noncontrolling interests" of the subsidiary, which are concepts not generally applicable for investment company financial reporting.

<sup>218</sup> See 17 CFR 270.8b-2 (stating that terms defined in the rule, when used in registration statements pursuant to Section 8 of the Investment Company Act and all reports pursuant to Section 30(a) or (b) of the Investment Company Act, shall have the meaning indicated in the rule). Investment Company Act forms that reference the term "significant subsidiary" include Form N-8B-4 for issuers of face-amount certificates, Form N-5 for small business investment companies, and Item B.11 of Form N-CEN.

<sup>219</sup> For example, Form N-14 used by registered investment companies and business development companies in connection with a business combination is a registration statement only under the Securities Act and not the Investment Company Act. Therefore, the definitions in Rule 8b-2 would not apply to a Form N-14 registration statement. See General Instruction A to Form N-14.

<sup>220</sup> See Section 59 of the Investment Company Act (15 U.S.C. 80a-58).

registration statements filed under the Securities Act.<sup>221</sup> In light of these circumstances, we believe that a specific test for investment companies would provide a more appropriate measure of significance given the differences in financial reporting of investment companies as compared to non-investment companies.

We also are proposing new Rule 6-11 of Regulation S-X, which would specifically cover financial reporting in the event of a fund acquisition and is modeled after proposed Rules 3-05 and 3-14.<sup>222</sup> Proposed Rule 6-11 would apply to the acquisition of another investment company, including a business development company, a private fund, and any private account managed by an investment adviser. Because the definition of business in Rule 11-01(d) is not readily applicable in the context of a fund acquisition, we propose a facts and circumstances test as to whether a fund acquisition has occurred, including when one fund acquires all or substantially all of another fund's portfolio investments.

Investment companies are also required to file audited financial statements for acquired funds, which can include private funds. Those private funds often have prepared audited financial statements in accordance with U.S. GAAP. However, private funds are not required to comply with the additional requirements set forth in Regulation S-X and therefore generally have not prepared their financial statements in accordance, nor had an audit conducted in compliance, with Regulation S-X. In these situations, an investment company registrant typically must revise or re-audit the historical financial statements of acquired funds so that they comply with all applicable rules within Regulation S-X.

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<sup>221</sup> See, e.g., Investment Management Guidance Update No. 2013-07, *Business Development Companies – Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries*, available at <https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-07.pdf>.

<sup>222</sup> In the event of a non-fund acquisition, investment companies would follow Rule 3-05.



We additionally propose to eliminate the current pro forma financial information requirement for investment companies and replace it with proposed Rule 6-11(d), which would require investment companies to provide supplemental financial information that we believe will be more relevant to investors.

### **1. Amendments to Significance Tests for Investment Companies**

As described in Section II.A.1, the definition of significant subsidiary in Rule 1-02(w) has three separate tests: the Investment Test, the Asset Test, and the Income Test. In contrast, the definition of significant subsidiary in Rule 8b-2 under the Investment Company Act has two tests:

- the Rule 8b-2 investment test, which looks to whether value of the investments in and advances to the subsidiary by its parent and the parent's other subsidiaries, if any exceed 10% of the value of the assets of the parent or, if a consolidated balance sheet is filed, the value of the assets of the parent and its consolidated subsidiaries; or
- the Rule 8b-2 income test, which looks to whether total investment income of the subsidiary or, in the case of a noninvestment company subsidiary, the net income exceeds 10% of the total investment income of the parent or, if consolidated statements are filed, 10% of the total investment income of the parent and its consolidated subsidiaries.

Calculations for these tests are made using amounts determined under U.S. GAAP.<sup>223</sup> Rule 8b-2 does not include an asset test.

We propose to add new Rule 1-02(w)(2) to create a separate definition of significant subsidiary for investment companies in Regulation S-X, which would use an investment test and

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<sup>223</sup> See Rule 1-02(w).

an income test, but not an asset test. The proposed definition would use a modified version of the current Rule 8b-2 tests. We also propose conforming amendments to Rule 8b-2 to make it consistent with proposed Rule 1-02(w)(2).<sup>224</sup> The changes to the significant subsidiary definition in Regulation S-X would affect disclosures for fund acquisitions and also have effects on investment company application of Rule 3-09 regarding separate financial statements for significant subsidiaries and Rule 4-08(g) regarding summarized financial information of subsidiaries not consolidated. We believe that it is appropriate to apply consistent significance tests for each of these provisions, particularly as proposed Rule 1-02(w)(2) is intended to be specifically tailored for investment companies. We believe that the proposed definition would avoid unnecessary regulatory complexity and the potential confusion associated with the existing definitions and provide more appropriate standards for determining significance for financial disclosure.

#### **a. Investment Test**

The Investment Test for significant subsidiary in Regulation S-X determines significance by determining whether the investments in and advances to the tested subsidiary<sup>225</sup> exceed 10% of the registrant's total assets. Rule 8b-2 similarly determines significance using an investment test. For investment companies, we propose to establish an investment test that compares whether the value of the registrant's and its other subsidiaries' investment in and advances to the

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<sup>224</sup> In conforming Rule 8b-2, we propose to eliminate paragraph (k)(3) of that rule and instead follow the syntax of proposed Rule 1-02(w) which more simply states that a significant subsidiary means a subsidiary, including its subsidiaries, which meets any of the specified conditions.

<sup>225</sup> See *supra* note 37 (regarding the use of the term "tested subsidiary"). Rule 1-02(w) defines the term "significant subsidiary." Proposed Rule 6-11 as well as Rules 3-09 and 4-08(g) use the conditions in Rule 1-02(w) when establishing the test for registrants to determine whether additional financial disclosures are required for investment company registrants.

tested subsidiary exceeds 10% of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

Our proposed investment test would be similar to the existing Investment Test, but modified so that the comparison would be to the value of the registrant's total investments<sup>226</sup> rather than total assets. Value of the investments would be determined in accordance with U.S. GAAP<sup>227</sup> and, if applicable, such as in the case of investment company registrants, Section 2(a)(41) of the Investment Company Act. We believe that the proposed total investments measure would be more appropriate for investment companies and more relevant than the existing tests, because it would focus the significance determination on the impact to the registrant's investment portfolio as opposed to other non-investment assets that may be held.

In addition, under Rule 6-05 of Regulation S-X, investment company registrants may substitute a statement of net assets in lieu of a balance sheet if at least 95% of total assets are represented by investments in securities of unaffiliated issuers. In such situations, the registrant will not file with the Commission a balance sheet that discloses total assets. We believe using total investments for the proposed investment test for investment companies would be a more transparent measure than total assets for registrants that use a statement of net assets instead of a balance sheet.

#### **b. Asset Test**

The Asset Test in Rule 1-02(w) compares the proportionate share of the total assets (after intercompany eliminations) of the tested subsidiary to the total assets of the registrant and its subsidiaries consolidated as of the end of the most recent fiscal year. There is no equivalent test

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<sup>226</sup> See 17 CFR 210.6-04.4.

<sup>227</sup> See FASB ASC 820 (fair value measurements).

under the Rule 8b-2 definition of significant subsidiary. We propose eliminating the Asset Test from Regulation S-X as a measure of significance for investment companies because we believe doing so would simplify compliance without changing the information available to investors.

The Asset Test is generally not meaningful when applied to investment companies. For example, if the tested subsidiary is another investment company, comparing the value of the registrant's proportionate share in that subsidiary to the registrant's total assets creates a test nearly identical to the proposed investment test. Because total investments is a component of total assets on the balance sheet of an investment company, the condition under the proposed investment test would always be satisfied before the condition of the Asset Test. In this context, the Asset Test becomes superfluous.

Additionally, applying the Asset Test is less straightforward for investment companies than for non-investment companies when the tested subsidiary is not an investment company.<sup>228</sup> The assets of non-investment companies are generally based on historical cost, while the assets of investment companies are based on market price or fair value. Thus, applying the Asset Test becomes less meaningful for investment companies as it requires comparing assets measured under different methodologies and therefore may be a less reliable indicator of significance.

### **c. Income Test**

The Income Test in Rule 1-02(w) compares the registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes exclusive of amounts attributable to any noncontrolling interests. The income test in Rule 8b-2, however, compares the total investment income of the tested subsidiary with the total investment income of the

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<sup>228</sup> In the event the tested subsidiary is another investment company, the assets of that subsidiary would principally be portfolio investments valued under U.S. GAAP and, if applicable, Section 2(a)(41) of the Investment Company Act.

parent and its consolidated subsidiaries. Both tests find significance if the result is greater than 10%. We believe that the income test in Rule 8b-2 is more appropriate because it uses income elements that are actually reported by investment companies. We propose to use that test, but modified to include any net realized gains and losses and net change in unrealized gains and losses.

The proposed income test for investment companies specifically uses components from the statement of operations required by Rule 6-07. In particular, the proposed income test for investment companies would include, in the numerator, the following amounts for the most recently completed pre-acquisition fiscal year of the tested subsidiary: (1) investment income, such as dividends, interest, and other income; (2) the net realized gains and losses on investments; and (3) the net change in unrealized gains and losses.<sup>229</sup> We believe that including changes in realized and unrealized gains/losses can better reflect the impact of the tested subsidiary on an investment portfolio rather than investment income alone, especially if volatility in the value of the investment portfolio is significantly greater than investment income or if there are significant holdings of securities that do not produce investment income. The sum of the absolute value of these amounts would be compared to the absolute value of the registrant and its subsidiaries' consolidated change in net assets resulting from operations.<sup>230</sup> We propose using the change in net assets resulting from operations because it is the equivalent to net income for non-investment companies.

We also propose to amend the significance threshold for the income test in Rule 1-02(w)

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<sup>229</sup> See, e.g., descriptions of these terms in Rules 6-07.1, 6-07.7(a), and 6-07.7(d) and equivalents under U.S. GAAP for non-registrants.

<sup>230</sup> See Rule 6-07.9. The absolute value would be calculated using the amounts set forth in the statement of operations.

as it applies to investment companies. We propose that a tested subsidiary will be deemed significant under the income test for investment companies if the test yields a condition of greater than either (1) 80% by itself or (2) 10% *and* the investment test for investment companies yields a result of greater than 5% (“alternate income test”). As with non-investment companies, the current Income Test may indicate significance and can result in additional financial information about the tested subsidiary being required<sup>231</sup> even though the tested subsidiary represents a very small component of the registrant’s investment portfolio. We believe that the proposed threshold changes would reduce the need to produce additional financial information in situations where a registrant’s change in net assets resulting from operations is relatively small and better identify situations of significance in which additional disclosure is warranted.

We have proposed the 80% threshold based on the view that it represents a level of significance that more accurately indicates the need for additional financial disclosure, especially for funds with relatively small amounts of income.<sup>232</sup> In these situations, the proposed income test threshold for investment companies, which is eight times greater, should result in fewer registrants with significance findings than under the current Income Test that uses a 10% threshold. To further mitigate the potential adverse effects of the proposed income test for investment companies with insignificant changes in net assets resulting from operations for the most recently completed fiscal year, we propose an instruction that permits the registrant to compute the income test for investment companies using the average of the absolute value of the changes in net assets for the past five fiscal years.<sup>233</sup>

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<sup>231</sup> See Rules 3-09 and 4-08(g).

<sup>232</sup> See Rule 3-05(b)(4)(iii).

<sup>233</sup> This approach is similar to that proposed when applying the revenue test for non-investment company registrants that have no recurring annual revenues. See *supra* note 48 and accompanying text.

We believe that a bright-line threshold for the proposed income test for investment companies would be less costly to apply than a principles-based approach as an initial determination of significance. To the extent that an investment company registrant exceeds the 80% threshold under the income test for investment companies and believes that the tested subsidiary is not significant, the registrant can engage with our staff and seek to omit separate financial statements for that subsidiary or substitute financial statements, which the staff may grant pursuant to Rule 3-13 and delegated authority.<sup>234</sup> For situations where the 80% threshold is not exceeded but the impact of a tested subsidiary's income may be significant, we believe that the proposed alternate income test would appropriately capture significance for financial reporting purposes.

The proposed alternate income test for investment companies would retain the existing 10% threshold for income significance but add an additional condition of more than 5% under the proposed investment test. We believe that the addition of a minimal percentage of the investment portfolio will eliminate many of the anomalous findings of significance as compared to the current 10% condition for net income alone. We have chosen 5% for the minimum because it is consistent with the 5% threshold utilized in Rule 6-05 for purposes of allowing the presentation of a statement of net assets in lieu of a balance sheet.

### **Request for Comment**

73. Should we create a separate definition of significant subsidiary in Rule 1-02(w) of Regulation S-X specifically for investment companies? If so, is the proposed definition appropriate when used for Rules 3-09 and 4-08(g) and proposed Rule 6-11 with respect to investment companies?

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<sup>234</sup> See *supra* note 215.

74. Should we make corresponding changes to the definition of significant subsidiary in Rule 8b-2? Are there reasons, with respect to investment companies, that the definitions of significant subsidiary in Rule 8b-2 and Regulation S-X should differ?
75. Should we utilize the value of total investments of an investment company as a denominator rather than total assets for the proposed investment test for investment companies? Should we change the numerator to a different metric than value of investments in and advances to the tested subsidiary? If so, which metric and why? Should we use the definition of value from the Investment Company Act for purposes of the Regulation S-X definition of significant subsidiary?
76. Should an asset test apply to investment companies? Are there situations in which an asset test would uniquely identify a significant subsidiary? If we were to retain an asset test for investment companies, how could it be modified to better reflect measures of significance relevant to investment companies?
77. Should we establish an income test for investment companies to utilize the absolute value of the sum of: (1) investment income, such as interest, dividend, and other income; (2) change in unrealized gain/loss; and (3) realized gain/loss as the numerator? If so, should we also change the denominator to be the investment company's absolute value of change in assets resulting from operations? Should we use absolute values of these entries from the statement of operations or should we use the absolute value of the gain or loss on each individual portfolio security? Are there other measures we should consider?
78. Should we increase the threshold of the income test for investment companies to 80%? Should we make the proposed income test for investment companies conjunctive with the proposed investment test for investment companies? Are the proposed thresholds of 10%



and 5% appropriate or should they be different? If different, what thresholds should we use to make the proposed income test conjunctive with the proposed investment test?

79. Should we base the proposed income test for investment companies on the individual absolute value of the components rather than netting them out? For example, in a fund with significant investment income, that income could be offset by an equal amount of realized and unrealized losses, creating a relatively small change in net assets resulting from operations. If we were to use the absolute value of each of the components, should we reduce the threshold of the proposed income test?
80. Under our proposal, a five-year average would be used for the income test for investment companies if the registrant and its subsidiaries consolidated has an insignificant change in net assets resulting from operations for the most recent fiscal year. Should the five-year average also be required for the tested subsidiary under similar circumstances? Should this proposed amendment be more similar to the one for non-investment company registrants? Should a five-year average be required only if the absolute value of the change in net assets resulting from operations for the most recent fiscal year is at least 10% lower than the average of the absolute value of such amounts for the registrant for each of its last five years?
81. We are proposing amendments to Rule 1-02(w)(2) to assist investment company registrants in making significance determinations. Are the proposed amendments appropriate? If not, are there different or additional amendments we should consider?
82. Should we make further modifications to the proposed income test for investment companies in situations where the tested subsidiary is not an investment company? For example, should we require the use of net income for a non-investment company

subsidiary when compared to the registrant's change in net assets resulting from operations?

83. Instead of having specific percentage conditions, should we adopt a materiality standard?

For example, should we adopt a standard that deems a subsidiary as significant if it is material to an understanding of the registrant's financial condition?

## **2. Proposed Rule 6-11 of Regulation S-X**

We are proposing new Rule 6-11 to address the financial statements of funds acquired or to be acquired, if probable, which would be based on proposed Rules 3-05 and 3-14 but modified to meet the needs of investment companies and their investors. Proposed Rule 6-11 would only apply to the acquisition of a fund, including any investment company as defined in Section 3(a) of the Investment Company Act, any private fund that would be an investment company but for the exclusions provided by Sections 3(c)(1) or 3(c)(7) of that Act, or any private account managed by an investment adviser. Proposed Rule 6-11 calls for a facts and circumstances evaluation as to whether a fund acquisition has occurred or is probable. We believe this approach captures the appropriate universe of fund acquisitions where additional disclosures may be appropriate, as it is based on the economic substance of a transaction rather than legal form. Under proposed Rule 6-11, the acquisition of all or substantially all portfolio investments held by another fund would be considered a fund acquisition; otherwise, potential disclosure obligations could be avoided by structuring an acquisition transaction as a sale of all assets rather than a merger.

We propose to require only one year of audited financial statements for fund acquisitions, a change from the existing Rule 3-05 requirements that require between one and three years of audited financial statements. This proposed change would make the obligations more aligned

with the financial statement obligations applicable to investment company registration statements. Rule 3-18 allows registered investment management companies to file financial statements covering only the most recent fiscal year, except for an audited statement of changes in net assets which must cover the two most recent fiscal years.<sup>235</sup> Older historical financial statements are generally less relevant to fund investors because the price of investment company shares or interests is established by the value of its investment portfolio, even for closed-end funds that may trade at a discount to net asset value and private funds that do not readily trade. Moreover, the proposed change would also be consistent with the practice of our disclosure review staff during consultations, which have permitted investment company registrants to provide financial statements for acquired funds for the periods set forth in Rule 3-18 rather than Rule 3-05.<sup>236</sup>

Under proposed Rule 6-11, the related schedules specified in Article 12 would need to be provided for an acquired or to be acquired fund. These schedules, such as the schedule of investments, are important for investment company registrants because they permit an investor to know the specific portfolio investments being acquired. The nature of investment companies, whose assets largely consist of portfolio investments that are carried at market value, if available, or fair value, makes other historical financial statement information less relevant than for non-investment companies.

Acquisitions of a group of related funds would be considered as a single acquisition

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<sup>235</sup> Business development companies are also permitted to use Rule 3-18 pursuant to the instructions set forth in Form N-2.

<sup>236</sup> See *supra* note 215.

under proposed Rule 6-11(a)(3)<sup>237</sup> and a registrant would have the option of presenting the required financial statements either on an individual or combined basis for any periods they are under common control or management. This provision is comparable to the treatment of related businesses under current and proposed Rule 3-05 and for similar reasons we believe it would be appropriate in the context of fund acquisitions.

In the investment company context, we believe that information about the composition of the acquired fund's investment portfolio is the most important and relevant information for investors. We understand that a significant number of private funds currently prepare audited financial statements under U.S. GAAP due to investor demand and for regulatory compliance purposes.<sup>238</sup> Therefore, we propose to allow investment companies to provide financial statements for private funds that were prepared in accordance with U.S. GAAP. However, we also are proposing to require the investment company registrant to file schedules for the acquired fund that comply with Article 12 of Regulation S-X, which requires each investment to be listed separately. Because the proposed rule would require the schedule of investments as set forth in Article 12, a private fund would not be permitted to present a condensed schedule of investments. We believe that our proposed approach with respect to acquisitions of private funds will reduce the costs related to re-issuing audited financial statements in compliance with Regulation S-X, but still provide investors appropriate information about the acquired fund.

Private fund financial statements prepared in accordance with U.S. GAAP do not require the same level of granular information or disclosure as financial statements prepared in

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<sup>237</sup> Funds are considered related if they are under common control or management, the acquisition of one fund is conditional on the acquisition of each other fund, or each acquisition is conditioned on a single common event.

<sup>238</sup> For example, one reason would be to satisfy custody rule obligations under the Investment Advisers Act. *See* 17 CFR 275.206(4)-2.

compliance with Regulation S-X. For example, certain financial statements prepared in compliance with Regulation S-X require separate disclosure of major categories or accounts greater than a certain percentage of total assets, liabilities, income or expenses while U.S. GAAP requirements are less specific. Additionally, under Regulation S-X, registered investment companies and business development companies must separately show certain financial statement accounts within the financial statements, regardless of their materiality, based on their affiliate classification in relation to the fund.<sup>239</sup>

Currently, a registrant that acquires a private fund typically must revise the historical financial statements of the acquired fund so that they comply with all applicable rules of Regulation S-X and possibly re-audit those statements. This is the case because the financial statements of private funds are generally prepared, in practice, in accordance with U.S. GAAP only. This can be costly both in terms of time and resources and, given the information contained in the acquired private fund audited financial statements that comply with U.S. GAAP, it is not clear that there is a commensurate benefit to investors by requiring financial statements of the acquired fund that comply with all provisions of Regulation S-X. Therefore, our proposal is intended to achieve an appropriate balance by permitting registrants to file U.S. GAAP financial statements for acquired private funds, but supplementing those financial statements with schedules listing each investment as required by Article 12.

To determine whether financial statements of a fund acquired or to be acquired must be provided under proposed Rule 6-11, the conditions specified in the definition of significant subsidiary under proposed Rule 1-02(w)(2) would be applied, using the investment test and the alternate income test for investment companies and substituting 20% for 10% for each place it

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<sup>239</sup> See, e.g., the financial reporting requirements of Rule 6-07 and FASB ASC 946-210-50-4 and 946-210-50-6.

appears therein. We have based the 20% significance test on comparable conditions in current Rule 3-05 and have not identified any reason to use a different threshold. The income test for investment companies with the 80% condition would not be used for purposes of proposed Rule 6-11 because we believe, in the acquisition context, significance matters principally with respect to the portfolio investments and the amount of assets being acquired, since investment income and realized and unrealized gains/losses from the investments acquired will be immediately reflected in the daily net asset value of the registrant. If either of the tests is satisfied at the 20% condition, the registrant would be required to file the financial statements for the acquired fund as set forth in proposed Rule 6-11. Otherwise, filing financial statements of the acquired fund would not be necessary.

If the aggregate impact of individually insignificant funds acquired or to be acquired since the most recent audited balance sheet exceeds the conditions of the investment test and the alternate income test for investment companies, substituting 50% for 10%, then the registrant would be required to provide the financial statements for each individually insignificant fund and the supplemental financial information. We have based the 50% condition on the provision in current Rule 3-05(b)(2)(i). Unlike the existing rule, however, proposed Rule 6-11 would require financial statements for each individually insignificant fund acquired or to be acquired, rather than the “substantial majority” requirement for businesses acquired under the current rule.

In determining whether financial statements of funds acquired or to be acquired must be filed, the registrant may use pro forma amounts that give effect to an acquisition consummated after the registrant’s latest fiscal year-end for which the registrant has filed audited financial statements of such acquired fund as required by proposed Rule 6-11. Any requirement to file financial statements of an acquired fund would cease once an audited balance sheet required by

Rules 3-01 or 3-18 is filed for a date after the date the acquisition was consummated. At such time, the acquired investments would be reflected on the balance sheet or statement of net assets and accompanying schedules. In these circumstances, we believe that historical financial statements of acquired funds would be of less importance to investors and continued filing obligations would impose unnecessary costs since any realized and unrealized gains/losses on the acquired investments would be reflected in the daily net asset value calculation as well as fund performance measures on a going-forward basis.

### **Request for Comment**

84. Should we adopt proposed Rule 6-11 for acquisitions of funds by registrants? Have we appropriately defined what constitutes a fund acquisition? Are there other types of private funds not covered by the Section 3(c)(1) or 3(c)(7) exclusion that should be covered? Is it appropriate to use a facts and circumstances-based evaluation to determine whether a fund acquisition has or will occur? Are there are other factors that should be considered in defining a fund acquisition?
85. Should we permit the presentation of audited financial statements of acquired funds for only the most recent fiscal year? Should we require the same reporting periods required by Rule 3-18 instead? If so, should we permit any registered investment company registrant, such as unit investment trusts, to use Rule 3-18 and not limit it to only registered management investment companies?
86. Should we treat business development companies and registered investment companies the same? Should business development companies follow the reporting periods set forth in proposed Rule 3-05 instead of proposed Rule 6-11?
87. Should we require registrants to provide the audited schedules required by Article 12 for

an acquired private fund, including a schedule of investments that requires each investment to be listed separately? Should we require only a smaller set of schedules required by Article 12, such as those required by Rules 12-12, 12-12A, 12-12B, 12-12C, and 12-13? Should we allow registrants to provide schedules that are permitted under U.S. GAAP rather than Article 12?

88. Is there any other disclosure by a registrant or an acquired fund that would be important to a fund investor? If so, please specify in detail.
89. Should we permit registrants to have the option to file financial statements on an individual or a combined basis for acquired funds that are part of a group of related funds for any periods they are under common control or management?
90. Should we continue to use the significant subsidiary definition as the basis for evaluating whether financial statements of an acquired fund should be filed? If so, is 20% the appropriate threshold? If not, what would be the appropriate threshold?
91. Should we not apply the 80% income test for purposes of determining whether financial statements of an acquired fund should be filed?
92. Should we permit a registrant to cease providing audited financial statements of the acquired fund once an audited balance sheet for the registrant is filed that reflects the assets of the acquired fund? Should the registrant be required to continue to file audited financial statements of the acquired fund until an audited statement of operations for a complete fiscal year reflecting the acquired fund has been filed?
93. Is it appropriate to permit the financial statements of an acquired private fund to comply with U.S. GAAP and only the schedule requirements in Article 12? Should we require Article 12 schedules to be filed with respect to the acquired private fund, even though it



may be likely to result in additional costs?

94. Is the proposed language related to independence standards sufficiently clear? Should we specify the “applicable independence standards”? If so, how should they be specified? Are there circumstances where there are no “applicable independence standards”? In those circumstances, which independence standards should apply?

### **3. Pro Forma Financial Information and Supplemental Financial Information**

We propose to eliminate the requirement to provide pro forma financial information for investment company registrants in connection with fund acquisitions and to provide more relevant disclosures in its place. Rule 11-01 requires an investment company to furnish pro forma financial information when a significant business acquisition has occurred or is probable, with significance being determined using the tests set forth in Rule 1-02(w) and substituting 20% for 10%. In the staff’s experience, investment companies often file Rule 3-05 Financial Statements in transactions in which an investment company with limited assets and operating history is created for the purpose of acquiring one or more private funds. After such an acquisition, the portfolio investments of the acquired fund will represent nearly all of the portfolio investments of the registrant, rendering the pro forma financial statements of the registrant to be substantially similar to the historical financial statements of the acquired fund that are already provided in the registration statement. Rule 11-02 permits investment companies to provide a narrative description of the pro forma effects of the transaction in lieu of pro forma financial statements, if there are a limited number of required pro forma adjustments and they are easily understood.<sup>240</sup>

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<sup>240</sup> See Rule 11-02(b)(1).

Applying the current pro forma financial information requirements, based on rules that are principally designed for non-investment companies, to fund acquisitions by investment companies may increase costs borne by investors without yielding significant benefit. Pro forma financial information in the investment company context may be less informative than other financial information. For example, non-investment company registrants are required to include historical financial statements and pro forma financial information in the registrant's prospectus. For investment companies, this information is placed in the statement of additional information (SAI) and not the prospectus. The absence of pro forma information from the prospectus is notable because the Commission has previously concluded that the prospectus, standing alone, contains all of "the information that is necessary or appropriate in the public interest or for the protection of investors."<sup>241</sup> The SAI, on the other hand, contains information not required in the prospectus but which "may be of interest to at least some investors."<sup>242</sup>

Preparation of pro forma financial information imposes costs on investment company registrants, and a significant percentage of filings on Form N-14 contain pro forma financial information. Our staff reviewed approximately 450 filings on Form N-14 over the past three years, using analytical tools to identify filings with pro forma information and found that approximately 50% of N-14 filings included pro forma financial statements and an additional 25% included narrative pro forma information.

When the Commission adopted Form N-14 in 1985, it stated that pro forma and historical financial information "may be useful" to investors, even though some commenters indicated that

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<sup>241</sup> *Registration Form Used by Open-End Management Investment Companies; Guidelines*, Release No. IC-13436 (Aug. 12, 1983) [(48 FR 37928, 37930) (Aug. 22, 1983)] ("Form N-1A Adopting Release").

<sup>242</sup> *Id.* at 37928. Today, all SAIs and the rest of an investment company's registration statements and other filings are available to investors on the Commission's EDGAR system. In addition, for investment companies that use a summary prospectus, the SAI must be posted to the fund's website. *See* 17 CFR 230.498(e).

the information was not material.<sup>243</sup> In response to the 2015 Request for Comment, several commenters suggested that historical financial statements and pro forma financial information were not material, particularly if an audited schedule of investments from the acquired fund was provided.<sup>244</sup> We believe that it is appropriate to re-consider whether pro forma financial information is necessary in light of the costs to prepare such disclosures.

In place of the current pro forma financial information requirements, we propose new Rule 6-11(d) to require that investment companies provide supplemental information about the newly combined entity that we believe will be more relevant to investors. The supplemental information would include: (1) a pro forma fee table, setting forth the post-transaction fee structure of the combined entity; (2) if the transaction will result in a material change in the acquired fund's investment portfolio due to investment restrictions,<sup>245</sup> 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 (3) narrative disclosure about material differences in accounting policies of the acquired fund when compared to the newly combined entity. We believe that this amendment would provide material information to investors because it would highlight important changes resulting from a fund acquisition (i.e., changes in fees and expenses, changes to acquired fund's holdings, and changes in accounting policies) to provide appropriate context to the acquired fund's financial statements.

### **Request for Comment**

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<sup>243</sup> *Business Combination Transactions; New Registration Form for Investment Companies*, Release No. IC-14796 (Nov. 14, 1985) [50 FR 48379 (Nov. 25, 1985)].

<sup>244</sup> See letters from CAQ, Crowe, and RSM.

<sup>245</sup> One example is if the registrant and the acquired fund both have positions in the same portfolio investment and, when combined, the registrant would exceed an investment restriction on any single holding. In this situation, a certain percentage of the portfolio investment may need to be divested.

95. Should we eliminate the requirement for investment companies to provide pro forma financial statements for the combined entity after a business acquisition? To what extent does pro forma financial information remain material in the investment company context? Please provide specific examples of how the current pro forma financial information is utilized.
96. Should we require the pro forma fee table, schedule of investments, and narrative disclosure as outlined above? Is there other information we should require in lieu of pro forma financial statements of the combined entity? If so, what other information would be material to investors?

#### **4. Amendments to Form N-14**

Item 14 of Form N-14, the form used by investment companies to register securities issued in business acquisition transactions,<sup>246</sup> provides, subject to certain exceptions, that the corresponding Statement of Additional Information “shall contain the financial statements and schedules of the acquiring company and the company to be acquired required by Regulation S-X.”<sup>247</sup> We propose to amend Form N-14 so that its disclosure requirements are consistent with the disclosures required in proposed Rule 6-11 because we believe it is appropriate for investors who acquire securities in a registered offering to have the same disclosure that investors receive through financial statement disclosure in shareholder reports. In the case of a fund acquisition, any financial statements and schedules required by Regulation S-X would only be required for

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<sup>246</sup> See 17 CFR 239.23 (setting forth the requirement for an investment company to file Form N-14 to register securities in business combination transactions) and 17 CFR 230.145 (specifying the types of transactions that trigger the Form N-14 filing requirement).

<sup>247</sup> See Item 14 of Form N-14. Currently, the disclosures are to be for the periods specified in Article 3 of Regulation S-X. *Id.*

the most recent fiscal year and the most recent interim period.<sup>248</sup> Similarly, we propose to permit private funds to provide financial statements and schedules that conform to U.S. GAAP and Article 12 of the Regulation S-X. We also propose to require inclusion of the supplemental financial information described in proposed Rule 6-11(d), except for the pro forma fee table. We are excluding the pro forma fee table from Item 14 of Form N-14 because it is already required in the prospectus under Item 3 of that Form. We also propose to remove provisions no longer relevant because of prior amendments.<sup>249</sup> We further propose to remove the existing exclusion in Form N-14 for pro forma financial statements required by Rule 11-01 of Regulation S-X if the net asset value of the company being acquired does not exceed 10% of the registrant's net asset value because pro forma financial statements would be no longer required for fund acquisitions and, for non-fund acquisitions, the significance measure for pro forma statements in Rule 11-01(b)(1) is and would remain 20%.

### **Request for Comment**

97. Should we conform the financial statement disclosure requirements in Item 14 of Form N-14 with proposed Rule 6-11? If not, how and why should the disclosures differ?

98. Should we require the supplemental financial information to be disclosed in Form N-14?

### **III. General Request for Comment**

We request and encourage any interested person to submit comments on any aspect of the proposal, other matters that might have an impact on the amendments, and any suggestions for

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<sup>248</sup> Non-fund acquisitions would be required to follow the other financial statement disclosure requirements set forth in Regulation S-X for the periods required by Rule 3-05, including any pro forma financial information required by Article 11.

<sup>249</sup> Specifically, we are removing the ability to place columns C and D of Schedule II under Rule 12-14 to Part C of the registration statement, with the remainder of the schedule being provided in the SAI. When originally adopted, Form N-14 was based on Form N-1A, which had a similar provision. *See* Form N-1A Adopting Release. This provision was removed from Form N-1A in 1998. *See Registration Form Used by Open-End Management Investment Companies*, Release No. 33-7512 [63 FR 13916 (Mar. 23, 1998)].

additional changes. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments, particularly quantitative information as to the costs and benefits, and by alternatives to the proposals where appropriate. Where alternatives to the proposals are suggested, please include information as to the costs and benefits of those alternatives.

#### **IV. Economic Analysis**

##### **A. Introduction**

We are proposing amendments to our rules and forms to improve the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses, including real estate operations and investment companies. The intended economic effects of the proposed amendments are to reduce the burden on registrants of complying with financial statement disclosure requirements related to their business acquisitions and business dispositions, facilitate timely access to capital, and provide more relevant information to investors. This reduced compliance burden also may encourage registrants to engage in more potentially value-enhancing mergers and acquisitions than they otherwise would engage in without the proposed amendments. However, business acquisitions and dispositions take place for many reasons, which could make it difficult to isolate the effects of the proposal from the effects of a host of potentially confounding factors.

Providing timely, accurate, and transparent information, especially financial information, about acquired or disposed businesses is important to mitigate the information asymmetry that exists between corporate insiders (managers and majority shareholders) and outsiders (minority shareholders, creditors, etc.). This is especially true in the context of major corporate transactions such as mergers, acquisitions, and dispositions, as investors rely on the financial

information of the acquired and disposed businesses to assess the potential effects of these activities on the registrant. A properly functioning market for corporate control serves as an important external governance mechanism involving transactions that potentially create shareholder value through synergy generation or transferring assets to more efficient management.<sup>250</sup> However, in the absence of appropriate disclosures, investors may not be able to fully assess the effects of this important external governance mechanism on the firms in which they invest.

At the same time, such disclosure requirements impose costs on registrants that could deter them from engaging in, or diminish the benefits associated with, acquisitions that are value-enhancing, for example, where the acquirer has to negotiate for information that may be costly and burdensome for the acquiree to prepare and provide. Further, a registrant's ability to provide such disclosure for periods prior to its acquisition is often dependent on both the acquired business and the acquired business's independent auditor. A registrant's inability to timely obtain such disclosure from these parties may impact its ability to comply with its reporting requirements and to access capital within the timeframes it desires. Thus, streamlining and clarifying acquired business financial disclosure requirements should reduce the likelihood that such requirements undermine the economic benefits of potentially value-enhancing transactions, or otherwise discourage registrants from engaging in such transactions, while maintaining investors' access to information that is likely to be material to an understanding of the potential effects of an acquired or to be acquired business on the registrant.

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<sup>250</sup> See, e.g., M. Mitchell and K. Lehn, 1990, "Do Bad Bidders Become Good Targets?", *Journal of Political Economy*, Vol. 98; A. Agrawal and J. Jaffe, 2003, "Do Takeover Targets Underperform? Evidence from Operating and Stock Returns", *Journal of Financial and Quantitative Analysis*, Vol 38.

We are mindful of the costs imposed by and the benefits obtained from our rules and amendments. Section 2(b) of the Securities Act,<sup>251</sup> Section 3(f) of the Exchange Act,<sup>252</sup> and Section 2(c) of the Investment Company Act<sup>253</sup> require the Commission, when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Additionally, Section 23(a)(2) of the Exchange Act<sup>254</sup> requires us, when adopting rules under the Exchange Act, to consider, among other things, the impact that any new rule would have on competition and not to adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the Exchange Act.

Below we address the potential economic effects of the proposed amendments, including the likely benefits and costs, as well as the likely effects on efficiency, competition, and capital formation. We attempt to quantify these economic effects when possible; however, due to data limitations, we are not able to quantify all of the economic effects.

## **B. Baseline and Affected Parties**

The current disclosure requirements in Rule 3-05, Rule 3-14, Article 11, and the related smaller reporting company requirements in Article 8 of Regulation S-X, together with the current disclosure practices registrants have adopted to comply with these requirements form the baseline from which we estimate the likely economic effects of the proposed amendments.<sup>255</sup>

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<sup>251</sup> 15 U.S.C. 77b(b).

<sup>252</sup> 17 U.S.C. 78c(f).

<sup>253</sup> 15 U.S.C. 80a-2(c).

<sup>254</sup> 15 U.S.C. 78w(a)(2).

<sup>255</sup> *See supra* Section I.



The proposals are likely to affect investors both directly and indirectly through other users of the disclosure (e.g., security analysts, investment advisers, and portfolio managers), auditors, and registrants subject to Regulation S-X. Additionally, entities other than registrants may be affected, such as significant acquirees for which financial statements are required under Rule 3-05 and Rule 3-14.

The proposed amendments may affect both domestic registrants and foreign private issuers.<sup>256</sup> We estimate that during calendar year 2018, approximately 6,919 registrants filed on domestic forms<sup>257</sup> and 806 foreign private issuers filed on F-forms, other than registered investment companies. Among the registrants that file on domestic forms, approximately 29% are large accelerated filers, 19% are accelerated filers, 19% are non-accelerated filers, and 33% are smaller reporting companies. In addition, we estimate that approximately 21.3% of these domestic issuers were emerging growth companies.<sup>258</sup> About 19.8% of foreign private issuers that filed on Forms 20-F and 40-F were emerging growth companies. With respect to foreign private issuer accounting standards, approximately 38% of foreign private issuers reported under U.S. GAAP, 61% reported under IFRS-IASB, and approximately 1% reported under Another Comprehensive Body of Accounting Principles with a reconciliation to U.S. GAAP. Certain of

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<sup>256</sup> The number of domestic registrants and foreign private issuers affected by the proposed amendments is estimated as the number of unique companies, identified by Central Index Key (CIK), that filed Form 10-K, Form 10-Q, Form 20-F, and Form 40-F or an amendment thereto with the Commission during calendar year 2018. The estimates for the percentages of smaller reporting companies are based on information from Form 10-K, Form 20-F, and Form 40-F. The estimates for the percentages of foreign private issuers' basis of accounting used to prepare the financial statements are derived from the information in Forms 20-F and 40-F. These estimates do not include issuers that filed only initial registration statements during calendar year 2018, which will also be affected by the amendments

<sup>257</sup> This number includes fewer than 25 foreign private issuers that file on domestic forms and approximately 100 business development companies.

<sup>258</sup> Staff determined whether a registrant claimed emerging growth company status by parsing several types of filings (e.g., Forms S-1, S-1/A, 10-K, 10-Q, 8-K, 20-F/40-F, and 6-K) filed by the registrant, with supplemental data drawn from Ives Group Audit Analytics.

the proposed amendments may also affect requirements applicable to issuers that rely on Regulation A and investment companies that must comply with the requirements of Regulation S-X.

Registrants are required to file separate audited annual and unaudited interim pre-acquisition financial statements of the acquired business if the acquisition triggers the Rule 1-02(w) significance tests as modified by Rule 3-05 and Rule 3-14. Because the United States has one of the most active markets for mergers and acquisitions,<sup>259</sup> the proposed amendments could affect disclosure for a large number of businesses. Registrants would potentially be affected by the proposed amendments if they engage in an acquisition or disposition transaction (or series of transactions) that is deemed significant under the Rule 1-02(w) significance tests as modified by Rule 3-05 and Rule 3-14 or the related smaller reporting company requirements in Article 8.

We are not able to observe the universe of acquisitions by all registrants, as acquisitions made by registrants that are not deemed significant or where the acquired businesses are not public firms might not be identified. For purposes of our Paperwork Reduction Act (“PRA”) analysis, we searched various form types filed from January 1, 2017 to October 1, 2018 for indications of acquisition or disposition disclosure.<sup>260</sup> In the reviewed period there were approximately 1,261 filings on various forms that included Rule 3-05 Financial Statements or Rule 3-14 Financial Statements, representing between approximately 1% and 12% of such filings, depending on the specific form.<sup>261</sup> To get a sense of overall market activity for mergers

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<sup>259</sup> A. K. Sundaram, 2004, “Mergers and Acquisitions and Corporate Governance,” *Mergers and Acquisitions* 3: 193-219; and 2018 J.P. Morgan Global M&A Outlook, available at: <https://www.jpmorgan.com/jmpdf/1320746694177.pdf>.

<sup>260</sup> See Section V.B.1. below for our review of forms filed by operating companies. We discuss our similar review of investment company forms in Section V.B.2. below.

<sup>261</sup> Based on a review of Forms 10, S-1, S-3, F-1, F-3, and 8-K. See Table 2 in Section V.B.1.

and acquisitions, we also examined mergers and acquisitions data from Thomson Reuters' Security Data Company ("SDC"). During the period from January 1, 2016 to December 31, 2018, there were 6,310 mergers and acquisitions entered into by publicly-listed U.S. firms. Among these transactions, 1,388 acquisitions involved non-U.S. targets and 442 were conducted by entities in the real estate industry.<sup>262</sup> Additionally, 294 of the 6,310 transactions were conducted by smaller reporting companies. These estimates constitute an upper bound on the number of transactions that may have triggered disclosure requirements under Rule 3-05 or Rule 3-14, and the related requirements for smaller reporting companies,<sup>263</sup> as many of these transactions may have involved acquisitions that are small relative to the size of the registrant.<sup>264</sup>

All investment companies that make fund acquisitions significant enough to trigger Rule 3-05 disclosure requirements would potentially be affected by the proposed amendments. Among registered investment companies, as of the end of calendar year 2018, there were 8,059 open-end funds, 1,988 exchange-traded funds, and 518 closed-end funds. In addition, there were 102 business development companies. We are not able to observe the universe of the fund acquisitions, however, we are able to observe those transactions that triggered the filing of acquired fund financial statements. In our PRA analysis, we searched various form types over a

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<sup>262</sup> Real estate industries are defined based on Standard Industry Classification code (SIC) in 6500s where either the acquiring companies or the acquiree has the primary SIC code in 6500s.

<sup>263</sup> Acquisitions that triggered Rule 3-05 or Rule 3-14 Financial Statements requirements are observed by searching EDGAR filings. Databases such as SDC have some coverage of mergers and acquisitions conducted by public listed firms in the U.S. However, when the acquired entities are privately owned, we do not have data in terms of their assets, income, and often the purchase prices paid by the acquiring firms. Thus we are not able to provide statistics on the relative size of these transactions.

<sup>264</sup> R. Masulis, C. Wang, and F. Xie, 2007 "Corporate Governance and Acquirer Returns" *Journal of Finance*, 62(4), 1851-1899 (reporting that the mean (median) relative size of the mergers in their sample is around 16% (6%) for the period of 1990-2003). Relative size in this study is measured as the ratio of target market cap to the acquirer market cap, and the sample is limited to public firms. We expect the relative size of the acquisitions for non-public acquirees would be even smaller, but we do not have data on the size of private firms to provide comparable statistics about these transactions.

three-year period ended October 1, 2018 for indications of fund acquisition disclosure. Among the 152 filings on Form N-14 for fund transactions, about 70 filings or 46% included acquired fund financial statements. There were only a few filings on Form N-1A and Form N-2 that included acquired fund financial statements (12 filings out of 8,936 filings on Form N-1A and two filings out of 132 filings on Form N-2).<sup>265</sup>

### **C. Potential Benefits and Costs of the Proposed Amendments**

#### **Potential Benefits**

We anticipate the proposed amendments<sup>266</sup> would improve the financial information about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure. Improved disclosure benefits users of financial information and can facilitate more efficient allocations of capital, while a reduced disclosure burden can shorten the time period to prepare disclosures necessary to access capital and typically generates cost savings for registrants, which can result in more capital being available for investment.

The proposed amendments may increase the utility of acquisition and disposition related disclosures to investors by making these disclosures more relevant. The proposed amendments should improve the salience of the information for investors by reducing the volume of information presented about acquired businesses and focusing the disclosures on more decision-relevant information. This, in turn, could lead to more informed investment decisions and improved capital allocation efficiency.

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<sup>265</sup> See *infra* Section V.B.2, Table 5.

<sup>266</sup> See *supra* Sections II.A. through II.E.

The proposed amendments may also permit more timely access to capital. A registrant's ability to provide existing required disclosure for periods prior to an acquisition is often dependent on both the acquired (or to be acquired) business and its independent auditor. The age of the acquired or to be acquired business's required financial statements, as well as changes in the acquired business's personnel or its independent auditor that occurred during the historical periods for which financial statements may be required through the acquisition date, can impair a registrant's ability to comply with its reporting requirements and access capital within the timeframes it needs to operate its business and make investments. By focusing on more recent historical periods, relying on more relevant disclosure triggers and definitions, and increasing the relevance of pro forma financial information, the proposed amendments should help to ameliorate these impediments, as we discuss in more detail below.

Further, to the extent that the proposed amendments reduce the compliance burden, they may reduce the cost of merger and acquisition activity. Well-functioning markets for corporate control are, on average, beneficial to investors as they serve as a disciplinary mechanism in which less efficiently managed assets are transferred to more efficient management. Mergers and acquisitions may also generate synergies by combining two entities, and may result in firms with more efficient scale or scope.

### **Potential Costs**

We do not expect the proposed amendments to generate significant costs for registrants. However, in certain situations the proposed amendments could cause some acquisitions to be significant that are not currently deemed significant by acquirers. In these situations, registrants would need to file Rule 3-05 Financial Statements, resulting in costs to registrants but potential benefits to investors in the form of enhanced disclosure related to the transaction. We also do

not anticipate significant costs to investors associated with the proposed amendments. We acknowledge that in some cases, the proposed amendments would reduce disclosure. However, we anticipate that the potential loss of information would be partially mitigated by a registrant's obligation under Rule 4-01(a) Regulation S-X to include such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading. Below we discuss the anticipated economic benefits and costs of specific aspects of the proposed amendments in further detail.

### **1. Significance Tests**

The proposed changes to the significance tests used under Rules 3-05 and 3-14 should help facilitate registrants' application of the tests. The proposed amendments could potentially increase the likelihood that the Investment Test is more in line with the economic significance of transactions and reduce anomalous results from the Income Test. This, in turn, should help reduce compliance burdens associated with preparing Rule 3-05 or Rule 3-14 Financial Statements for an acquired business.

First, the proposed change to the Investment Test using the registrant's aggregate worldwide market value rather than its historical book value of total assets may better reflect the relative size of the transaction in economic terms. The investment in and advances to the acquired business generally reflect an acquirer's expectation of the fundamental value of the equity of the acquired business.<sup>267</sup> Similarly, using market value of the registrant would be more in line with the market expectation of the registrant's discounted future free cash flow to equity

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<sup>267</sup> The fundamental value of an entity's equity refers to the value of equity determined through fundamental analysis. For example, fundamental value of a firm's equity can be estimated by summing the discounted stream of expected future free cash flow to the firm's equity holders.

holders, and thus may more accurately reflect the fundamental value of the registrant's equity. By better aligning these two components of the Investment Test, the proposed amendments would potentially avoid classifying transactions as significant when they are actually insignificant in economic substance to the registrant. Further, market values may better reflect the relative size of the transaction, especially for high growth acquiring registrants whose market value is significantly different from their book value.<sup>268</sup>

Second, the proposed changes to the Income Test to simplify the calculations and to add a revenue component should improve the application of the Income Test. These proposed changes are likely to mitigate the effect of infrequent expenses, gains, and losses on the calculation and also potentially prevent deeming as significant immaterial acquisitions by registrants with net income or loss near zero. Moreover, the proposed change to require the use of readily available income or loss after tax likely would reduce compliance burden for registrants as in some cases, the calculation of income before taxes requires adjustment of line items that are generally presented on an after-tax basis.

Both proposed amendments to the significance tests are expected to better capture the importance of the acquisitions relative to the registrant. To the extent that the proposed changes reduce the risk of deeming an insignificant acquisition to be significant, they may benefit registrants by reducing the number of instances in which registrants are required to file Rule 3-05 Financial Statements or Rule 3-14 Financial Statements, thus reducing compliance burdens. To the extent that the proposed modifications to the significance tests capture more significant acquisitions and fewer insignificant ones, they may directly benefit investors by improving the

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<sup>268</sup> See, e.g., A. Shleifer and R. Vishny, 2003, "Stock Market Driven Acquisitions", *Journal of Financial Economics*.

overall salience of the information disclosed to them. Investors may also indirectly benefit from the proposed changes to the significance tests as the potential cost savings from reduced compliance burdens could be translated to more capital available to the registrants for future profitable investments and possibly the ability to access capital sooner than under existing requirements.

The use of market capitalization instead of book value could raise questions relating to whether market price reflects a registrant's fundamental value and the appropriate measurement period to be used. If a firm's stock price is informationally efficient, it will reflect the fundamental value of the firm's equity. Any new information, including information about mergers or acquisitions, might lead investors to revise their expectations of the firm's risk and future cash flow, resulting in possible changes in stock price. Information about a transaction sometimes starts seeping into the stock market several months before an announcement, leading investors to speculate around potential mergers or acquisitions.<sup>269</sup> Thus, the market price of the registrant's shares might fluctuate depending on the information available. These and other factors could potentially affect stock price or the firm's market value. Thus, it is possible that the proposed changes to the Investment Test might introduce errors or bias into the determination of the significance of an acquisition.

Additionally, inclusion of a revenue component in the Income Test may result in an acquired business that has a significant impact on net income, but not on revenues, not being deemed significant. When the registrant and its subsidiaries consolidated and the tested subsidiary have recurring annual revenue, the proposed Income Test would require both the new

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<sup>269</sup> P.J. Halpern, 1973 "Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers" *The Journal of Business*, 46, (4), 554-575; G. Mandelker, 1974" Risk and Return: The Case of Merging Firms" *Journal of Financial Economics*, 1, (4), 303-335.



revenue component and the net income component to be met.<sup>270</sup> As a result, when the profitability of the registrant differs significantly from the profitability of the acquired business, the income component could generate a very different result from the revenue component. This could lead to under-identification of significant transactions when, for example, a high revenue, low profit firm acquires a low revenue, high profit firm.

In Section II above, we solicit comment on the impact of these measurement issues on investors and registrants. We preliminarily believe, however, that the proposed changes to the significance tests would improve the application of the tests and their ability to capture the economic substance of acquisitions and dispositions, which would benefit investors by helping ensure that they are provided with decision-relevant information about those acquisitions.

## **2. Audited Financial Statements for Significant Acquisitions**

The proposed amendment to eliminate the requirement to file the third year of Rule 3-05 Financial Statements would reduce registrants' disclosure burden. Currently, Rule 3-05 Financial Statements are required for up to three years prior to the acquisition depending on the significance of the transaction and the amount of net revenues reported by the acquired business in its most recent fiscal year. To the extent that information from three years prior might be less relevant to investors' analysis of an acquisition, we preliminarily believe the benefits from the potential reduction in disclosure burden and audit costs could justify investors' loss of the incremental value of the third year of financial information. For purposes of the PRA, we expect the average reduction in registrants' compliance burden as a result of the proposed amendments

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<sup>270</sup> In this case, the registrant would use the lower of the revenue component and the net income component to determine the number of periods for which Rule 3-05 Financial Statements are required. *See* proposed Rule 3-05(b)(2) of Regulation S-X.

would be approximately 125 hours per Rule 3-05 Financial Statement filing.<sup>271</sup> In addition to these compliance cost savings, there could be other and more substantial benefits from the proposed amendments. For example, if the preparation and audit of pre-acquisition financial statements are outside of the registrant's control, and the target company is unable to prepare and obtain an audit of any required financial statements for the third year, the registrant will be unable to comply with its disclosure requirements under Rule 3-05, which could delay the filing of a registration statement and hence its capital raising efforts.

The impact of the proposed amendment on investors depends, in part, on the value of information about the third year. In an efficient market, information for the third year before an acquisition may not generally provide significant incremental value to investors to evaluate a transaction. However, in some cases the omission of the third year of Rule 3-05 Financial Statements could result in loss of information to investors, such as in those limited cases where the acquired business has an operating cycle that extends beyond two years and has not previously filed any financial reports. We expect this potential loss of information to be partially mitigated by a registrant's Rule 4-01(a) obligation to include such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

### **3. Financial Statements for Net Assets that Constitute a Business and Financial Statements of a Business that includes Oil-and-Gas-Producing Activities**

The proposed amendment to permit the use of abbreviated financial statements in circumstances where providing full audited financial statements would be impractical should reduce registrants' disclosure burdens, decrease compliance costs, and facilitate the application

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<sup>271</sup> See Table 1 in Section V.B.1.

of Rule 3-05. Registrants frequently acquire a component of an entity that is a business as defined in Rule 11-01(d), but does not constitute a separate entity, subsidiary, or division, such as a product line, a line of business contained in more than one subsidiary of the selling entity, or an interest in oil and gas producing activities that generates substantially all of its revenues from oil and gas producing activities. These businesses may not have separate financial statements or maintain separate and distinct accounts necessary to prepare Rule 3-05 Financial Statements because they often represent only a smaller portion of the selling entity. As a result, a registrant may be unable to provide the financial statements required under the current rule. In these circumstances, the proposed amendments provide specific conditions under which registrants would be permitted to file abbreviated financial statements to comply with Rule 3-05. There would be no need for the registrant to seek relief from the staff, thus reducing the compliance burden. We believe allowing for abbreviated financial statements in these circumstances could help reduce costs for registrants, and because registrants must otherwise disclose material information about the acquisition that is necessary to make the required statements not misleading, we expect that these cost reductions could be realized without negatively affecting investors.

#### **4. Timing and Terminology of Financial Statement Requirements**

The proposed amendments include several revisions that clarify the timing and some terminology related to the disclosure requirements. These clarifications should benefit registrants by avoiding any confusion that may arise from application of the current requirements, thereby enhancing the overall efficiency of their compliance efforts. Because the proposed changes do not modify the information required to be disclosed, we do not believe investors would be negatively affected by these proposed changes. To the extent that these

proposed changes make compliance more efficient for registrants, investors may indirectly benefit as cost savings could be passed through to them.

## **5. Foreign Businesses**

The proposed amendments would allow Rule 3-05 and Rule 3-14 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant. Preparing financial statements without reconciliation to U.S. GAAP in these circumstances would reduce the compliance costs where an acquired business in a cross-border acquisition does not have U.S. GAAP financial statements. It may also expand the pool of foreign entities that would be considered valuable potential acquisition targets. For example, a registrant might be discouraged under the current rules from completing a cross-border acquisition in situations where it would be costly for the foreign target to prepare its financial statements using U.S. GAAP as required by the current rules.

The proposals would also permit foreign private issuers that prepare their financial statements using IFRS-IASB to provide Rule 3-05 and Rule 3-14 Financial Statements prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP. Permitting use of Rule 3-05 and Rule 3-14 Financial Statements reconciled to IFRS-IASB in these circumstances potentially benefits investors by providing them with information about the acquired business that is more comparable to the registrant. This may allow investors to analyze the impact of these acquisitions more expeditiously.

By providing flexibility to prepare an acquired (or to be acquired) business's financial statements using, or reconciling to, IFRS-IASB in these circumstances, the proposed amendment may facilitate certain cross-border mergers that might otherwise not take place due to

compliance costs associated with preparing financial statements using, or reconciling to, U.S. GAAP. Based on data from the SDC merger database for the three year period from January 2015 to January 2018, about 20% of acquisitions by U.S. companies involved non-U.S. targets. To the extent that the proposed amendment leads to increased cross-border mergers and acquisitions, shareholders could potentially benefit from greater growth potential in new markets, more efficient distribution systems, or improved managerial processes, among other benefits.<sup>272</sup>

A possible consequence from the proposed amendments would be inconsistencies in financial disclosure about acquired (or to be acquired) businesses where IFRS-IASB and U.S. GAAP differ significantly in reporting practices. For example, there are certain differences in the recognition, measurement, and impairment of long-lived assets between IFRS-IASB and U.S. GAAP.<sup>273</sup> Such inconsistencies could lead to confusion and a loss of comparability for investors of domestic registrants familiar with U.S. GAAP financial statements. Despite potential inconsistencies, we preliminarily do not expect the proposed amendment to impose substantial costs on investors. Foreign private issuers have been permitted to file IFRS-IASB financial statements without reconciliation to U.S. GAAP for some time,<sup>274</sup> and IFRS-IASB is widely used for financial reporting purposes in other jurisdictions. In that respect, we do not believe using or reconciling to IFRS-IASB financial statements for businesses in foreign jurisdictions would necessarily lower the disclosure standard or cause undue confusion. In addition, pro

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<sup>272</sup> See, e.g., K. Ahern, 2015, “Lost In Translation? The Effect of Culture on Mergers Around the World”, *Journal of Financial Economics*, 117, P165-189.

<sup>273</sup> As an example, IFRS-IASB permits the recognition of internally-generated intangible assets in limited circumstances; U.S. GAAP does not.

<sup>274</sup> See *Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP*, Release No. 33-8879 (Dec. 21, 2007) [73 FR 986 (January 4, 2008)].

forma financial information for the acquisition is required to reflect the acquired foreign business on the same basis of accounting as that of the registrant. For a U.S. registrant, that basis would be U.S. GAAP, which should mitigate any potential inconsistencies in the pre-acquisition historical financial statements. However, we encourage commenters to provide us with information about these potential costs.

**6. Omission of Rule 3-05 and Rule 3-14 Financial Statements and Related Pro Forma Financial Information for Businesses That Have Been Included in the Registrant's Financial Statements**

The proposed amendments allowing registrants to omit Rule 3-05 and Rule 3-14 Financial Statements from Securities Act registration statements and proxy statements after inclusion in post-acquisition results for a complete fiscal year could improve such registrants' timely access to capital. For example, registrants currently have to test the significance of acquisitions that occurred during the earliest years for which the registrant is required to provide historical financial statements and, if significant, to provide pre-acquisition financial statements of the acquired business. We expect the proposed amendments to be especially useful for registrants that complete an initial public offering, as those registrants are most likely not to have been required to file Rule 3-05 and Rule 3-14 Financial Statements before filing their initial registration statements. In these instances, a registrant might need to spend additional time or resources, or both, to prepare Rule 3-05 and Rule 3-14 Financial Statements for inclusion in a registration statement, which can delay a registrant's offering and hence delay its access to capital. In addition to anticipated benefits resulting from more timely access to capital, registrants may benefit from reduced compliance costs.

We believe that information from the historical pre-acquisition period is not as relevant once integration of the acquisition is completed. Additionally, in acquisitions where integration

takes longer than a year, investors would still receive disclosure about material effects of the acquisition through the registrant's management's discussion and analysis.<sup>275</sup> We therefore do not expect the proposed amendments to result in a meaningful loss of material information to investors. Instead, the reduction in compliance burdens and the timely access to capital may indirectly benefit investors.

#### **7. Use of Pro Forma Financial Information to Measure Significance**

The proposed amendments permit the use of pro forma financial information to measure significance in initial registration statements. This approach provides registrants with certain flexibility to more accurately measure the relative significance of an acquisition or disposition, which in turn may help reduce their disclosure burden and compliance costs and facilitate capital formation. Because pro forma financial statements may capture the likely effects of significant acquisitions and dispositions that are not fully reflected in the registrant's historical financial statements (financial statements that would otherwise be used to measure significance), these amendments could enable registrants to more accurately determine the significance of these transactions.

The proposed amendments could potentially reduce the amount of information presented to investors if significance determinations on the basis of pro forma financial statement information fail to identify acquisitions that are economically significant to a registrant. However, as noted above, Rule 4-01(a) requires registrants to include such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading. We expect this requirement to address concerns about any loss of relevant information to investors.

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<sup>275</sup> See 17 CFR 229.303.

## 8. Disclosure Requirements for Individually Insignificant Acquisitions

Registrants are currently required to provide certain audited, historical pre-acquisition financial statements if the aggregate impact of “individually insignificant businesses” acquired since the date of the most recent audited balance sheet exceeds 50%.<sup>276</sup> In these circumstances, pro forma financial information is also required pursuant to Article 11 for the “individually insignificant businesses” for which audited, historical pre-acquisition financial statements are required.<sup>277</sup> To comply with these requirements, registrants may need to provide audited financial statements of acquired businesses that are not material to the registrant, and pro forma financial information that might not reflect the aggregate effect of the “individually insignificant businesses.”

The proposed amendments would affect disclosure requirements for individually insignificant businesses in several ways. First, the proposed amendments would require the registrants to provide audited historical financial statements only for those acquired businesses whose individual significance exceeds 20%. Reducing required disclosure of audited historical financial statements for insignificant acquisitions could improve registrants’ access to capital since preparing such disclosure for these acquisitions typically entails negotiating with the seller to timely provide this information, a process that can be costly and time-consuming. By simplifying and streamlining the historical financial statement disclosure requirement for individually insignificant acquisitions, the proposed amendments may make it easier, quicker, and cheaper for registrants to access capital. The proposed amendments would also reduce registrants’ disclosure burdens leading to cost savings that may ultimately benefit shareholders.

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<sup>276</sup> See *supra* note 115.

<sup>277</sup> See *supra* note 118.



Second, the proposed amendments could improve the completeness of information provided to investors by requiring pro forma financial information that depicts the aggregate effect in all material respects of the acquired businesses, rather than only a mathematical majority of the individually insignificant businesses acquired. Investors might benefit by being able to more effectively assess the aggregate effect of these acquisitions on the registrant as a result of the proposed amendments.

The proposed amendment might impose additional compliance burdens on registrants because it could require registrants to present information about acquisitions, albeit in an aggregated form, that they have not disclosed in the past. Because we do not have information available to estimate the number of acquisitions that would be subject to this proposed requirement in aggregate or for any given registrant, we cannot quantify these compliance costs. However, we do not expect registrants to incur substantial costs to prepare disclosure about such acquisitions because these are activities that typically underpin the decision to make an acquisition.

**9. Rule 3-14 - Financial Statements of Real Estate Operations Acquired or to be Acquired**

The proposed amendments would align Rule 3-14 with Rule 3-05 where no unique industry considerations warrant differentiated treatment of real estate operations. For example, the proposed amendments would align the threshold for individual significance for both rules at “exceeds 20%” and the threshold for aggregate significance for both rules at “exceeds 50%”. The proposed amendments would also align Rule 3-14 and Rule 3-05 in terms of the years of required financial statements for acquisitions from related parties, the timing of filings, application of Rule 3-06, which permits the filing of financial statements covering a period of nine to 12 months, and other less significant changes.

The proposed amendments are expected to benefit registrants as greater consistency in application of the rules may reduce the costs of preparing disclosure, especially for registrants that make both real estate and non-real estate acquisitions. In addition to the alignment between Rule 3-14 and Rule 3-05, the proposed amendments also define real estate operation as a business that generates substantially all of its revenues through the leasing of real property. This may reduce potential uncertainty and ambiguity in applying Rule 3-14 without negatively affecting investors.

The proposed amendments would also establish or clarify the application of Rule 3-14 regarding scope of the requirements, determination of significance, need for interim income statements, and special provisions for blind pool offerings. The proposed amendments related to blind pool offerings are consistent with current practice for these offerings. Thus, while they may reduce potential compliance uncertainty and ambiguity for registrants, we do not expect the proposed amendments to have a substantial effect on current disclosure practices.

#### **10. Pro Forma Financial Information**

The proposed amendments to replace the existing pro forma adjustment criteria in Article 11 of Regulation S-X with Transaction Accounting Adjustments and Management's Adjustments would simplify these requirements and reduce potential inconsistency in preparing pro forma financial information. The proposed amendments to Article 11 could benefit investors in several ways. First, the proposed Transaction Accounting Adjustments may lead to more consistent pro forma presentations than the current adjustment criteria, which may be subject to some interpretation. In addition, the proposed Transaction Accounting Adjustments may permit registrants to better reflect the acquisition, disposition, or other transaction, which could help investors better understand the effects of the acquired business to the registrant's audited

historical financial statements. Likewise, the proposed Management's Adjustments, which require disclosure of reasonably estimable synergies and other transaction effects, such as closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements, that have occurred or are reasonably expected to occur, may give investors better insight into the potential effects of the transaction as contemplated by the company. This would potentially benefit investors in helping them to distinguish the accounting effects of the acquisitions from management's judgment as to the expected operational effects based on management plans. Altogether, the proposed amendments are expected to improve the relevance of the information disclosed to investors and help investors process information more effectively.

The proposed revisions to Article 11 could impose costs on registrants because they would be required to meet new presentation requirements for pro forma adjustments. For purposes of the PRA, we estimate the average incremental compliance burden for these new requirements would be around 25 hours per affected registrant.<sup>278</sup> Further, synergy estimation by registrants may introduce certain subjective judgments into the pro forma financial statements, potentially making them more difficult for investors to interpret. However, the proposed amendments also would require registrants to disclose uncertainties, assumptions, and calculation methods underlying the Management's Adjustments. This could mitigate the risk of biased pro forma adjustments by providing investors with more information to evaluate Management's Adjustments when analyzing the impact of an acquisition.

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<sup>278</sup> See Table 1 in Section V.B.1.

## **11. Significance and Business Dispositions**

The proposed amendment to conform the significance threshold for a disposed business to that of an acquired business and eliminate disclosure of less significant dispositions would reduce inconsistencies in reporting between acquisitions and dispositions and potentially reduce registrants' compliance burden.<sup>279</sup> For example, under the proposed amendments, registrants would not have to file pro forma financial information for insignificant dispositions (e.g., dispositions with significance levels exceeding 10% but not 20%), thus reducing compliance costs. In addition, there could be some positive spillover effect for registrants from applying the same thresholds to determine the significance of their transaction. For example, a registrant might engage in both acquisitions and dispositions during the same reporting period. Identical thresholds might help achieve internal consistency in financial reporting in evaluating the impact of both types of transactions as well as the net effects. For investors, the proposed amendment to conform the significance threshold for a disposed business to that of an acquired business could facilitate understanding and analysis of Rule 3-05 and Rule 11-01(b) disclosures by eliminating the inconsistency in reporting between acquisitions and dispositions.

## **12. Smaller Reporting Companies and Regulation A**

The proposed amendments would revise Rule 8-04 to direct smaller reporting companies to Rule 3-05 for requirements relating to the financial statements of businesses acquired or to be acquired, although the form and content requirements for these financial statements would continue to be governed by Article 8. The proposed revisions to Rule 8-04 would also apply to

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<sup>279</sup> Under current requirements, pro forma financial information is required upon the disposition (and for certain registration statements and proxy statements, the probable disposition of a significant portion of a business if the business to be disposed of meets the conditions of a significant subsidiary under Rule 1-02(w). Rule 1-02(w) uses a 10% significance threshold, not the 20% threshold used for business acquisitions under Rules 3-05 and 11-01(b).

issuers relying on Regulation A. Since the form and content of the required financial statements would continue to be prepared in accordance with Article 8, we do not believe the proposed amendments would impose additional compliance costs on affected entities and do not expect the amendments to reduce information available to investors.

The proposed amendments to require smaller reporting companies to provide pro forma financial information for significant acquisitions and dispositions made during annual periods and to use the enhanced guidelines in Article 11 when preparing pro forma financial information would increase the burden on smaller reporting companies. However, based on a staff analysis of 2017 disclosures of acquisitions and dispositions by smaller reporting companies, we believe most already comply with the conditions in Article 11.<sup>280</sup> As a result, we do not expect that the proposed amendments would impose significant new costs on these entities. At the same time, the proposed amendments to require smaller reporting companies to provide pro forma financial information for significant acquisitions and dispositions made during annual periods and to use the enhanced guidelines in Article 11 when preparing pro forma financial information may provide more relevant information to investors, although this benefit also would be limited to the extent that smaller reporting companies already comply with these requirements in practice.

### **13. Amendments to Financial Disclosure about Acquisitions Specific to Investment Companies**

We believe the proposed amendments related to investment companies would reduce compliance burdens by streamlining the disclosure requirements in a way that is tailored to the specific attributes of acquisitions made among investment companies. We do not anticipate significant costs to investors related to the proposed amendments, because we do not believe the

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<sup>280</sup> See *supra* note 208.

proposed amendments would result in a reduction in the volume of material information available to investors.

Currently, there are no specific rules or requirements in Regulation S-X for investment companies relating to the financial statements of acquired funds. Instead, these entities apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11. However, investment company registrants differ from non-investment company registrants in several respects. For example, investment companies' income mainly stems from capital appreciation and investment income;<sup>281</sup> investment companies are required to report their net asset value on a daily basis using fair value for portfolio investments; and investment companies do not account for their investments using the equity method. As a result, investment companies have faced challenges applying the general requirements of Rule 3-05 and Article 11 in the context of fund acquisitions.

The proposed amendments include a separate definition of significant subsidiary and separate significance tests specifically tailored for investment companies. The proposed amendments focus the significance determination for investment companies on the impact to the registrant's investment portfolio held by the registrant. Further, the proposed test would capture sources of income such as dividends, interest, and the net realized and unrealized gains and losses on investment that are most relevant to investment companies. We expect that together the proposed amendments would benefit both investment companies and their investors by providing more appropriate standards for determining the significance of fund acquisitions. For example, the proposed income test would better align income from a particular investment or acquisition for purposes of analyzing the effect on the income of the investment company as a

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<sup>281</sup> Investment income includes dividend, interest on securities, and other income, but does not include net realized and unrealized gains and losses on investments. *See* Rule 6-07 of Regulation S-X.

whole. We thus expect the proposed income test to better reflect the impact of the tested subsidiary on an investment portfolio rather than a test based solely on investment income as used in current Rule 8b-2. This is because changes in the market value of an investment portfolio due to market volatility may be substantial even when the securities held in the portfolio do not produce investment income.

As a result of these changes, the proposed amendments may more accurately identify acquisitions that are economically significant to investment company registrants. This would benefit registrants as they would not be required to prepare separate financial disclosure for economically insignificant acquisitions. The proposed amendments also may benefit investors to the extent that investors' attention now is inappropriately focused on economically insignificant acquisitions that are deemed significant under current rules. Furthermore, we do not anticipate the proposed significance tests would impose substantial costs on registrants to implement because we believe the required measures should be readily available to registrants.

The proposed change in the significance thresholds for the income test in Rule 1-02(w) when it applies to investment companies has two prongs – either a threshold of 80% for income alone or a 10% threshold with the investment test result higher than 5%. This proposed threshold change might reduce the compliance burden faced by investment companies as there would be less need to produce additional financial information when a registrant's net income is relatively small. Smaller net income could produce anomalous results under the current income test as it may make it appear as if an acquisition or investment is a significant contribution to a registrant's net income when it represents only a very small portion of the registrant's portfolio of investments. By effectively conditioning the income test for investment companies on the investment test for investment companies, the proposed amendments would potentially better

identify fund acquisitions that warrant additional disclosure. This proposed change also could benefit investors to the extent that they place a higher weight on the value of investments, relative to the income produced by investments, when considering the economic impact of an acquisition.

The proposed elimination of an asset-based test for investment companies would simplify compliance while likely not resulting in a significant loss in information. An asset-based test is generally not meaningful when applied to investment companies and, when the acquired entity is another investment company, would be largely superfluous in light of the proposed investment test. Additionally, applying the asset test could be less meaningful when the tested subsidiary is not another investment company. Because the asset test in these circumstances would involve comparing assets measured under different methodologies, it may be a less reliable indicator of significance, causing registrants to incur costs to prepare disclosures for acquisitions that are not economically significant – and therefore of little benefit to investors.

Proposed new Rule 6-11 potentially reduces compliance burdens by setting forth financial statement requirements for acquired funds that are specifically tailored for investment companies as compared to Rule 3-05. Proposed Rule 6-11 would consider the acquisition of all or substantially all portfolio investments held by another fund as a fund acquisition. This principles-based facts and circumstances evaluation of whether a fund acquisition has occurred could potentially reduce avoidance of any required acquired fund disclosures by focusing on economic substance rather than legal form. The proposed requirement of one year of audited financial statements for fund acquisitions and elimination of pro forma financial statements would also reduce compliance burdens for registrants. We do not believe these proposed amendments would lead to loss of relevant information to investors, as the price of investment



company shares is calculated daily based on the fair value of its investment portfolio and older historical financial statements are in general less relevant to fund investors. The proposed amendments also would be consistent with the accommodations typically provided by our disclosure review staff during consultations. The proposed use of permitting investment companies to provide financial statements for private funds that were prepared in accordance with U.S. GAAP would reduce compliance burdens for investment companies by potentially reducing the costs related to re-issuing audited financial statements in compliance with Regulation S-X. Any loss of information arising from these amendments would be mitigated by that fact that we are proposing to require investment companies to file the schedules required under Article 12 of Regulation S-X and to provide certain supplemental information regarding the acquired funds. We believe this information would be more relevant and potentially enhance the efficiency in processing the information by fund investors. These supplemental disclosures, however, would entail costs to registrants. For purposes of the PRA, we estimate the average incremental compliance burden for this additional disclosure would be around 25 hours per affected registrant. We further estimate that proposed Rule 6-11 would reduce a registrant's compliance burden by approximately 100 hours.

#### **D. The Effects on Efficiency, Competition, and Capital Formation**

We anticipate that the proposed amendments would have favorable effects on efficiency, competition, and capital formation for both operating companies and investment companies. Amendments that reduce disclosure burdens for registrants regarding business acquisitions would tend to facilitate registrants' engagement in acquisitions that otherwise might not take place due to barriers to compliance or other compliance costs. An active takeover market creates efficiencies by transferring inefficiently managed assets to more efficient management or by

creating synergies through economy of scale or economy of scope. On average mergers and acquisitions benefit investors in the acquired business.<sup>282</sup>

The proposed amendments to revise the disclosure relating to acquired and disposed businesses would benefit registrants by potentially reducing compliance burdens and facilitating more timely access to capital. Considering all registrants, including both operating companies and investment companies, for PRA purposes, the estimated reduction in the total number of incremental burden hours required for compliance with all forms from the proposed amendments is about 82,225 company hours.<sup>283</sup> The resulting total incremental professional costs for all forms under the proposed amendments would be a reduction of approximately \$21,470,000.<sup>284</sup> We believe the potential cost savings from the proposed amendments are significant.

At the same time, we do not believe investors would face a significant loss in information as a result of the proposed amendments. Instead, we expect that the proposed amendments would provide investors with more relevant information, which may allow them to process the information more efficiently, enhancing their investment decisions and thus potentially facilitating capital formation. Additionally, reduced regulatory complexity may lead to an increase in mergers and acquisitions. Under the existing disclosure requirements related to acquired businesses, some mergers may not be feasible due to the impracticality of compliance with Rule 3-05 Financial Statement requirements (e.g., a private business may not have more than two years of audited financial statements, but the transaction may trigger additional

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<sup>282</sup> Empirical studies have shown that around M&A announcements, the target firms earn a significant abnormal return (*See, e.g.,* G. Mandelker, 1974, “Risk and Return: The Case of Merging Firms” *Journal of Financial Economics*, 1, (4), 303-335; M.C. Jensen & R.S. Ruback, 1983, “The Market for Corporate Control: The Scientific Evidence” *Journal of Financial Economics*, 11, (1-4), 5-50.

<sup>283</sup> *See* Column E of Table 9 in Section V.C. below.

<sup>284</sup> *See* Column F of Table 9 in Section V.C. below.

disclosure because the business crosses the highest significance threshold). Under the proposed amendments, registrants might have access to a larger set of potential acquisitions. The proposed amendments may also facilitate potentially value-enhancing acquisitions that might otherwise not take place due to the impracticability of compliance with current rules. For example, the proposed amendments permitting the use of abbreviated financial statements when acquiring certain business lines may decrease the acquisition costs for registrants. This could promote competition in the market for mergers and acquisitions and potentially benefit shareholders of acquired businesses. Better disclosure quality and an improved information environment could also facilitate the market for mergers and acquisitions, which would help achieve efficient capital allocation and exert effective external control mechanisms on public firms, leading to an overall increase in efficiency.<sup>285</sup>

## **E. Alternatives Considered**

### **1. Approaches to the Significance Tests**

One alternative to the proposed significance tests would be to adopt a principles-based framework, such as materiality, rather than the current bright-line tests for determining when financial statements of acquired or to be acquired businesses are required. The benefit of using a principles-based approach based on materiality to determine significance is that it would permit judgment and consideration of unique facts and circumstances. An additional benefit of such an approach is that materiality is a familiar concept to registrants who currently make materiality determinations in preparing their filings with the Commission. However, while a principles-

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<sup>285</sup> Studies have found that mergers may create shareholder value when the assets are transferred from inefficient management to more efficient management. M. Mitchell and K. Lehn, 1990, “Do Bad Bidders Become Good Targets?”, *Journal of Political Economy*, Vol. 98; A. Agrawal and J. Jaffe, 2003, “Do Takeover Targets Underperform? Evidence from Operating and Stock Returns”, *Journal of Financial and Quantitative Analysis*, Vol 38. K. Lehn and M. Zhao, 2006, “CEO Turnovers after Acquisitions: Are Bad Bidders Fired?”, *Journal of Finance*, Vol 61.

based approach is frequently the appropriate standard for registrants to apply when preparing disclosures, determinations related to business acquisitions and dispositions pose unique challenges. Unlike periodic reporting, acquisitions and dispositions tend to be episodic, and moreover, there is less similarity between such transactions. As a result, it can be difficult for registrants to efficiently make a determination of materiality in an acquisition context, where timing considerations can be paramount.

Furthermore, unlike disclosure that relates solely to the registrant, which is prepared by the registrant on an ongoing basis, and where materiality is therefore evaluated regularly, in an acquisition context registrants must rely on information provided by third parties to make a determination of whether the acquisition is significant and whether the related disclosure is material. A bright-line test provides registrants with a level of certainty that allows them to efficiently make determinations of what level of disclosure is required in an environment where delay is costly. Also, where a registrant determines not to provide disclosure, investors would not receive information about the acquired business's financial impact on the registrant until the operating results of the acquired business have been reflected in the consolidated financial statements of the registrant for an extended period of time. As a result, the impact of the acquisition may be difficult for investors to disentangle from other events at the registrant, even where the acquisition may be economically significant. Thus, in summary, we expect a bright-line threshold in the case of these disclosures could be less costly for registrants and result in more consistent disclosure to investors where transactions are of economic significance to a registrant.

The Investment Test under the existing Rule 3-05 compares the registrant's investment in and advances to the acquired business against the carrying value of the registrant's total assets.

The proposed amendment to the “Investment Test” would use the aggregate worldwide market value of the registrant’s voting and non-voting common equity calculated on the last day of the most recent fiscal year at or prior to the acquisition. As an alternative to the proposed investment test, we could have proposed requiring registrants to use enterprise value for the acquirer and the acquired business, rather than the value of common equity (for the acquirer) and investment in and advances to the acquired business. Enterprise value may more comprehensively reflect the value of the entity because it includes equity, debt, minority interests, and preferred shares.

When a registrant makes an acquisition, depending on the ownership structure and capital structure of the registrant and the acquired business, the purchase price or investment in the acquired business would not necessarily reflect the total effect of the acquisition on the registrant, particularly if the acquired business is highly levered. Enterprise value would take into consideration the leverage of the acquired business and may, in such cases, better capture the economic effects of the transaction. Enterprise value, however, may not be appropriate for an acquirer or acquiree that has substantial liquid assets on its balance sheet. Additionally, enterprise value may not be a consistent indicator of relative size across registrants because capital structure (i.e., leverage) may be very different among registrants in certain industries.

With respect to the proposed modification to the Investment Test, as noted earlier, because investors react to news and information, the anticipation of an acquisition could cause a change in equity value of both the potential acquirer and the potential acquired firm. More generally, the market values of registrants are expected to change with market conditions as well as firm-specific information. As a result, it is possible that our proposed approach to the Investment Test, which would require measurement of investments in an acquisition against the acquirer’s aggregate worldwide market value on the last day of the most recent fiscal year at or

prior to an acquisition, might not reflect all the information about the value of the acquirer. As an alternative, we could have proposed to require the registrant to use its average market value over a period of time rather than on a specific day when measuring the size of its investments. This approach would avoid situations in which positive or negative market-wide or firm-specific shocks lead to noisy measures of market value that result in inaccurate assessments of significance, which may over- or under-identify significant acquisitions. However, using average market value could increase the costs and complexity of the proposed rule for registrants and would raise questions about the appropriate choice of a required measurement period (e.g., over a specified number of months or over the entire reporting period).

One alternative to the proposed Income Test would be to replace the existing income test with a revenue test. A potential benefit of this approach is that a revenue test would be less likely to produce anomalous results because it does not include infrequent expenses, gains, or losses that can distort the determination of relative significance. However, a stand-alone revenue test may not be a meaningful indicator of significance for the reasons the Commission described when it eliminated revenue as a standalone significance test.<sup>286</sup>

A second alternative to the proposed Income Test would involve switching from an income component to a revenue component when the acquirer's net income or loss is marginal or break-even. Such an alternative could rely on another financial ratio, such as return on assets, to identify instances where the acquirer's net income is sufficiently low to yield anomalous results from the income component. For example, under such an alternative, the revenue component would be used instead of the income component if the absolute value of the acquirer's return on

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<sup>286</sup> See Release No. 6359 (November 6, 1981) [46 FR 56171 (November 16, 1981)] (“The proposed amendment reflects the Commission’s view that the presentation of additional financial disclosures of an affiliated entity may not be meaningful in instances in which the affiliate has a high sales volume but a relatively low profit margin, and therefore has little financial impact on the operating results of the consolidated group.”).

assets were less than one percent. Relative to the proposed Income Test, such an alternative may have a lower risk of under-identification of significant transactions if the proposed revenue component causes transactions to not be significant under the Income Test when the acquirer's net income is not marginal or break-even and the Investment Test and Asset Test are not met. However, such an approach would require identifying a financial ratio to serve as the trigger for a switch from the income component to the revenue component and, absent calibration, such a ratio may yield inconsistent results across industries. For example, an appropriate threshold for return on assets may vary across industries depending on the extent of an acquirer's reliance on human capital versus material capital. Moreover, for those that rely heavily on material capital, the information provided by a return on assets threshold may be subsumed by the existing Asset Test.

A third alternative to the proposed Income Test would be to use an operating income or profit margin component instead of the income component. Operating income or profit margin could be a better indicator of significance than the income component in that it may eliminate the effects of non-operating items such as interest expense. However, not all registrants report these income measures, and these measures share the same issues as net income, which could lead to similarly anomalous results.

A final alternative to the proposed Income Test would be to lower the threshold required to meet the revenue component, for example to 15% or 10%. A potential benefit of this approach is that it may mitigate the risk of under-identification of significant transactions. However, it may be difficult to calibrate the income component and revenue component thresholds in a way that decreases the risk of under-identification without increasing the risk of over-identification.

## **2. Approaches to Proposed Financial Statement Requirements**

An alternative to the required Rule 3-05 or Rule 3-14 Financial Statements would be to require U.S. GAAP or IFRS-IASB, as applicable, business combination disclosures, which include, among other things, supplemental pro forma information about revenue and earnings for the two years prior to the acquisition. Under this regime, registrants are required to disclose information that enables users of a registrant's financial statements to evaluate the nature and financial effect of a business combination that occurs either: (a) during the current reporting period, or (b) after the reporting date but before the financial statements are issued or are available to be issued.<sup>287</sup> These disclosures would eventually be required to be included in registrants' historical audited financial statements presented for the period in which the acquisition occurred, although the supplemental information may continue to be labeled as unaudited. However, compared with our proposed approach, less information would be disclosed to investors under this alternative, and the information would not be audited. Further, guidance about the presentation and preparation of supplemental pro forma information is limited, which potentially may impact the consistency of pro forma presentations between registrants.

## **3. Approaches to Proposed Pro Forma Adjustments**

An alternative to the proposed Management's Adjustments for pro forma financial statements is to limit the Management's Adjustments to those that have been previously filed or furnished in Commission filings. A potential benefit of this approach is that it would permit the registrant to better determine whether and, if so, when forward-looking information should be

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<sup>287</sup> See FASB ASC 805-10-50-1.



disclosed. The disadvantage of this alternative is that pro forma disclosures may omit known information such as reasonably estimable synergies and other transaction effects that have occurred or are likely to occur. Also, under this alternative, pro forma disclosures may not depict the potential effect of the transaction on the registrant fully.

#### **4. Alternatives to the Proposed Income Test for Investment Companies**

One alternative to the proposed income test for investment companies would be to use the absolute value of gains and losses within the income test components rather than netting them. Because netting losses against gains mitigates the effect of individual securities on overall results of the portfolio, the use of absolute value of gains and losses for individual securities could result in a more accurate assessment of the effects of the acquired fund securities on the income of the acquiring fund. However, under this alternative, the registrant would need to re-calculate the gain or loss for each individual security using absolute value for both the acquiring fund and the acquired fund, rather than using existing financial measures that have already been determined for the financial statements, thereby increasing the cost and complexity of the proposed test for registrants without necessarily providing significant incremental benefits to investors.

Another alternative to the proposed income test for investment companies would be to select a percentage lower than 80% for the significance test. One potential benefit of using a lower percentage is that it could reduce the possibility that an investment company registrant would not need to provide disclosure for a fund acquisition with a material impact on the acquiring fund's income. However, it could also increase the possibility that costly disclosure obligations would be triggered, even though the impact on the registrant's assets is non-material (particularly if the income of the acquiring fund is relatively low). The proposed combination of income/investment test is intended to mitigate this result.

## **Request for Comment**

We request comment on all aspects of our economic analysis, including the potential costs and benefits of the proposed amendments and alternatives thereto, and whether the rules, if adopted, would promote efficiency, competition, and capital formation or have an impact on investor protection. Commenters are requested to provide empirical data, estimation methodologies, and other factual support for their views, in particular, on costs and benefits estimates.

### **V. Paperwork Reduction Act**

#### **A. Summary of the Collection of Information**

Certain provisions of our rules and forms that would be affected by the proposed amendments contain “collection of information” requirements within the meaning of the PRA.<sup>288</sup> The Commission is submitting the proposal to the Office of Management and Budget (“OMB”) for review in accordance with the PRA.<sup>289</sup> The hours and costs associated with preparing and filing the forms and reports constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information requirement unless it displays a currently valid OMB control number. Compliance with the information collections is mandatory. Responses to the information collections are not kept confidential and there is no mandatory retention period for the information disclosed. The titles for the affected collections of information are:<sup>290</sup>

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<sup>288</sup> See 44 U.S.C. 3501 *et seq.*

<sup>289</sup> 44 U.S.C. 3507(d) and 5 CFR 1320.11.

<sup>290</sup> A number of forms require audited financial statements and therefore could also include information required by Rule 3-05 and Rule 3-14 such that the proposed amendments could affect the PRA burden associated with those forms. Based on staff experience, however, Rule 3-05 or Rule 3-14 Financial Statements are not generally included in these forms. The potentially affected Forms include “Form S-4” (OMB Control No. 3235-0324), “Form S-11” (OMB Control No. 3235-0067), “Form F-4” (OMB Control No. 3235-0325), “Form

- “Regulation S-X” (OMB Control No. 3235-0009);<sup>291</sup>
- “Form S-1”<sup>292</sup> (OMB Control No. 3235-0065);
- “Form S-3”<sup>293</sup> (OMB Control No. 3235-0073);
- “Form F-1” (OMB Control No. 3235-0258);
- “Form F-3” (OMB Control No. 3235-0256);
- “Form 10”<sup>294</sup> (OMB Control No. 3235-0064);
- “Form 8-K” (OMB Control No. 3235-0060);
- “Form N-1A”<sup>295</sup> (OMB Control No. 3235-0307);
- “Form N-2”<sup>296</sup> (OMB Control No. 3235-0307);
- “Form N-14” (OMB Control No. 3235-0336); and
- “Form 1-A”<sup>297</sup> (OMB Control No. 3235-0286).

The regulations, schedules, and forms listed above were adopted under the Securities Act,

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20-F” (OMB Control No. 3235-0288), “Form 10-K” (OMB Control No. 3235-0063), “Regulation 14A” and “Schedule 14A” (OMB Control No. 3235-0059), “Regulation 14C” and “Schedule 14C” (OMB Control No. 3235-0057), “Form 10-Q” (OMB Control No. 3235-0070), “Form 1-K” (OMB Control No. 3235-0720), and “Form 1-SA” (OMB Control No. 3235-0721). While the proposed amendments would also apply to registered investment companies, based on staff experience, Rule 3-05 or Rule 3-14 Financial Statements are not generally included in “Form N-3” (OMB Control No. 3235-0316), “Form N-4” (OMB Control No. 3235-0318), “Form N-5” (OMB Control No. 3235-0169), and “Form N-6” (OMB Control No. 3235-0503). Because we do not expect these forms to be generally affected by the proposed amendments, we are not adjusting the burden estimates associated with these collections of information.

<sup>291</sup> The paperwork burden for Regulation S-X is imposed through the forms that are subject to the requirements in these regulations and are reflected in the analysis of those forms. To avoid a PRA inventory reflecting duplicative burdens, and for administrative convenience, we assign a one-hour burden to this regulation.

<sup>292</sup> 17 CFR 239.11.

<sup>293</sup> 17 CFR 239.13.

<sup>294</sup> 17 CFR 249.210.

<sup>295</sup> 17 CFR 239.15A; 17 CFR 274.11A.

<sup>296</sup> 17 CFR 239.14; 17 CFR 275.11a-1.

<sup>297</sup> 17 CFR 239.90.

the Exchange Act, and/or the Investment Company Act and set forth the disclosure requirements for registration statements, periodic and current reports, and distribution reports filed by registrants to help investors make informed investment and voting decisions.

We are proposing amendments to the financial statement requirements for acquired and disposed businesses in Rules 3-05 and 3-14 and related rules and forms. We are also proposing new Rule 6-11 and amendments to Form N-14 to specifically govern financial reporting for acquisitions involving investment companies. A description of the proposed amendments, including the need for the information and its proposed use as well as a description of the likely respondents can be found in Section II above, and a discussion of the economic effects of the proposed amendments can be found in Section III above.

**B. Proposed Amendments’ Effect on Existing Collections of Information**

**1. Estimated Effects of the Proposed Amendments on Paperwork Burdens for Registrants Other Than Investment Companies**

The following table summarizes the estimated effects of the proposed amendments on the paperwork burdens associated with the affected forms filed by registrants with operations or that otherwise are not investment companies.

**Table 1: Estimated Paperwork Burden Effects for Registrants (Excluding Investment Companies)**

Amendment	Estimated Effect and Affected Forms	Brief Explanation of Estimated Effect
Rule 3-05, Rule 3-14, and related rules (e.g., Rule 1-02(w))	A reduction of 125 burden hours for each of the following forms: 10, 1-A, S-1, S-3, F-1, F-3, and 8-K	<ul style="list-style-type: none"> <li>● This reduction is the estimated effect on the affected forms by the proposed amendments to Rules 3-05, 3-14, and the related rules (e.g., Rule 1-02(w)), when considered in the aggregate and compared to the paperwork burden under existing requirements.</li> <li>● For PRA purposes, we estimate that existing Rule 3-05 or Rule 3-14 Financial</li> </ul>

		Statements require an average of 500 burden hours. <sup>298</sup>
Article 11 (Rules 11-01, 11-02 and 11-03) and Rule 8-05 of Regulation S-X	An increase of 25 burden hours for each of the following forms: 10, 1-A, S-1, S-3, F-1, F-3, and 8-K	<ul style="list-style-type: none"> <li>● This increase is the estimated effect on the affected forms by the proposed amendments to the pro forma financial information requirements under Article 11, including the requirement to provide certain forward-looking information, and Rule 8-05 of Regulation S-X when considered in the aggregate and compared to the paperwork burden under existing requirements.</li> <li>● For PRA purposes, we estimate that existing pro forma financial information requires an average of 100 burden hours.<sup>299</sup></li> </ul>

**a. Proposed Amendments to Rules 3-05 and 3-14**

Considering the various revisions outlined in Sections II.B and C above, we estimate that the proposed amendments to Rule 3-05 and Rule 3-14 would generally reduce the paperwork burden for filings on an affected form that includes existing Rule 3-05 or Rule 3-14 Financial Statements. However, not all filings on the affected forms include these disclosures because they are provided only in certain instances. Therefore, to estimate the overall paperwork burden reduction from the proposed amendments, we first estimated the number of filings that include

<sup>298</sup> In response to the 2015 Request for Comment, no commenter provided information that would assist us in deriving an estimate for the cost of Rule 3-05 or Rule 3-14 Financial Statements. In order to develop an estimate of the number of burden hours required for an issuer to provide the existing financial statements, we have relied on information derived from staff discussions with registrants and consultants and from a review of recent waiver request letters that cited the cost of compliance. Two waiver request letters received in 2017 cited costs of complying with the Rule 3-05 Financial Statement requirements ranging from \$43,000 to \$200,000. Additionally, a consultant suggested a typical range of audit fees as \$100,000 to \$250,000 and consulting fees of \$40,000 to \$100,000. Using this data, we estimate that Rule 3-05 or Rule 3-14 Financial Statements require on average approximately 500 additional burden hours to prepare. We believe that this estimate falls within the range of costs suggested by the recent waiver requests and consultant's estimate and would appropriately account for company and professional hours required.

<sup>299</sup> In response to the 2015 Request for Comment, no commenter provided information that would assist us in deriving an estimate for the cost of pro forma financial information. In order to develop an estimate of the number of burden hours required for an issuer to provide pro forma financial information under existing rules, the staff relied on its discussions with registrants and consultants. Based on those discussions, we estimate that the required pro forma financial information would be equivalent to approximately 20% of the 500 total burden hours that we estimate would be required to prepare Rule 3-05 or Rule 3-14 Financial Statements. While pro forma financial information is an important aspect of acquired business financial information disclosure, it is only an incremental part of that disclosure, which also requires the production of acquired business historical financial statements and audits of those statements.

Rule 3-05 and Rule 3-14 Financial Statements. To do so, Commission staff searched the various form types filed from January 1, 2017 until October 1, 2018 for indications of acquisition or disposition disclosure.<sup>300</sup> Based on the staff’s findings, the table below sets forth our estimates of the number of filings on these forms that included Rule 3-05 or Rule 3-14 Financial Statements in calendar year 2017 and the first nine months of 2018.

**Table 2: Number of Filings on Affected Forms in the Reviewed 2017-2018 Period**

Form	Number of Filings (A)	Number of Filings Including 3-05 or 3-14 Financial Statements (B)	Percentage of Filings Affected (C)
10	198	18	9.1%
S-1	1,369	118	8.6%
S-3	1,415	164	11.6%
F-1	169	4	2.4%
F-3	321	8	2.5%
8-K	118195	949	0.8%

We used this data to extrapolate the effect of these changes on the paperwork burden. In order to appropriately adjust the current burden estimates, we applied these percentages to the current estimates for the number of responses in the Commission’s current OMB PRA filing inventory.<sup>301</sup>

<sup>300</sup> To develop these estimates, Commission staff searched and analyzed filings for the calendar year 2017 and the first nine months of 2018 on the Intelligize research platform. Commission staff then reviewed Forms S-1, S-3, F-1, F-3, S-11, 10, and 8-K, using text and other searches for appropriate word combinations. The staff then manually reviewed the filings to identify and more accurately determine which filings contained Rule 3-05 and Rule 3-14 Financial Statements.

<sup>301</sup> The OMB PRA filing inventories represent a three-year average. Averages may not align with the actual number of filings in any given year.

**Table 3: Calculation of the Number of Filings on Affected Forms For PRA Purposes**

	Number of Responses in Current PRA Estimates (A)	Estimated Percentage of Filings Affected (B)	Estimated Number of Filings Including 3-05 or 3-14 Financial Statements (C)
10	216	9.1%	20
1-A <sup>302</sup>	179	10.0%	18
S-1	901	8.6%	78
S-3	1657	11.6%	192
F-1	63	2.4%	2
F-3	112	2.5%	3
8-K	118,387	0.8%	947

**b. Proposed Amendments to Pro Forma Financial Information Requirements**

Considering the various revisions outlined in Section II.D above, we estimate that the proposed amendments to Article 11 and Rule 8-05 would reduce a registrant’s paperwork burden by simplifying disclosure requirements generally, but may increase burdens by requiring certain forward-looking information and, in the case of smaller reporting companies, requiring pro forma financial information in some additional circumstances<sup>303</sup> and requiring that the information be provided in a clearer and more robust manner. To estimate the overall paperwork burden reduction from the proposed amendments, we first estimated the number of filings that include Article 11 and Rule 8-05 pro forma financial information. Because pro forma financial information is most typically associated with acquisition and dispositions, we relied on the

<sup>302</sup> Based on data from domestic registration statements, we estimate that approximately 10% of Forms 1-A would be affected.

<sup>303</sup> The additional circumstances that would require a smaller reporting company to present pro forma financial information under the proposed amendments would include: roll-up transactions as defined in 17 CFR 229.901(c); when such presentation is necessary to reflect the operations and financial position of the smaller reporting company as an autonomous entity; and other events transactions for which disclosure of pro forma financial information would be material to investors.

estimates of affected forms that we determined for the Rule 3-05 and Rule 3-14 burden estimates, as set forth in Table 2 above.

## 2. Estimated Effects of the Proposed Amendments on Paperwork Burdens for Investment Company Registrants

The following table summarizes the estimated effects of the proposed amendments on the paperwork burdens associated with the affected forms filed by investment companies.

**Table 4: Estimated Paperwork Burden Effects for Investment Companies**

Amendment	Estimated Effect and Affected Forms	Brief Explanation of Estimated Effect
Proposed Rule 6-11, Rule 1-02(w), Article 11 of Regulation S-X, and Form N-14	A reduction of 100 burden hours for each filing that contains acquired fund financial information on the following forms: N-1A, N-2 and N-14	<ul style="list-style-type: none"> <li>● This reduction is derived from an estimated reduction of 125 burden hours resulting from the proposed amendments discussed in Section II.E. above<sup>304</sup> compared to existing Rule 3-05 and pro forma financial information requirements.<sup>305</sup></li> <li>● This reduction was then offset by an estimated increase of 25 burden hours for the proposed schedules and supplemental information under proposed Rule 6-11.<sup>306</sup></li> </ul>

Considering the various revisions outlined in Section II.E above, we estimate that proposed Rule 6-11 and the related amendments would generally reduce the paperwork burden for filings on an affected form that currently includes Rule 3-05 Financial Statements. However, not all filings on the affected forms include these disclosures. Therefore, to estimate the overall

<sup>304</sup> This estimated reduction of 125 burden hours is due to the proposed changes affecting the required reporting periods and pro forma financial information and permitting the use of U.S. GAAP-compliant financial statements for acquired private funds. *See, e.g.*, Section II.E.2.

<sup>305</sup> To determine the paperwork burden for a registrant to make disclosures in accordance with the proposed Rule 6-11 and proposed amendments to Form N-14, we estimated the number of burden hours required for an issuer to provide the existing financial statements. As previously noted, for PRA purposes, we estimate that existing Rule 3-05 Financial Statements require an average of 500 burden hours. *See supra* note 298.

<sup>306</sup> *See supra* Section II.E.2 and II.E.3.



paperwork burden reduction from the proposed amendments, we first estimated the number of filings that include acquired fund financial statements. To do so, we searched the various form types over a three-year period ended October 1, 2018 for indications of fund acquisition disclosure.<sup>307</sup> The table below sets forth our estimates of the number of filings on these forms that included acquired fund financial statements in that period.

**Table 5: Number of Filings on Affected Investment Company Forms (2016-2018)**

Form	Avg. Annual Number of Filings (A)	Number of Filings Including Acquired Fund Financial Statements (B)	Percentage of Filings Affected (C)
N-1A	8,936	12	0.0013
N-2	132	2	0.15 %
N-14	152	70	46%

We used this data to extrapolate the effect of these changes on the paperwork burden. In order to appropriately adjust the current burden estimates, we applied these percentages to the estimates of the number of responses in the Commission’s current OMB PRA filing inventory.

**Table 6: Calculation of the Number of Filings on Affected Investment Company Forms For PRA Purposes**

	Number of Responses in Current PRA Estimates (A)	Estimated Percentage of Filings Affected (B)	Estimated Number of Filings Including Acquired Fund Financial Statements (C)
N-1A	6,002	0.0013	8
N-2	166	0.15%	3
N-14	192	46%	88

### C. Aggregate Burden and Cost Estimates for the Proposed Amendments

<sup>307</sup> To conduct this analysis, Commission staff used text-based search terms of filings made through the EDGAR system to identify filings that may contain acquired fund financial statements and pro forma financial information from investment company registrants. However, the use of text-based search terms may understate the actual number of instances. Because the number of filings varied from year to year, we use an average over a three-year period.

Below we estimate the aggregate change in paperwork burden as a result of the proposed amendments. These estimates represent the average burden for all registrants, both large and small. In deriving our estimates, we recognize that the burdens will likely vary among individual registrants based on a number of factors, including the nature of their business. The burden estimates were calculated by multiplying the estimated number of responses by the estimated average amount of time it would take a registrant to prepare and review disclosure required under the proposed amendments. The portion of the burden carried by outside professionals is reflected as a cost,<sup>308</sup> while the portion of the burden carried by the registrant internally is reflected in hours.<sup>309</sup>

The tables below illustrate the change to the total annual compliance burden of affected forms, in hours and in costs, as a result of the proposed amendments.

**Table 7: Calculation of the Reduction in Burden Estimates of Current Responses Due to the Proposed Amendments to Rule 3-05 and Rule 3-14 and Pro Forma Financial Information Requirements**

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<sup>308</sup> We recognize that the costs of retaining outside professionals may vary depending on the nature of the professional services, but for purposes of this PRA analysis, we estimate that such costs would be an average of \$400 per hour. This estimate is based on consultations with several registrants, law firms, and other persons who regularly assist registrants in preparing and filing reports with the Commission.

<sup>309</sup> For purposes of the PRA, we estimate that 75% of the burden of preparation of Forms 8-K and 1-A is carried by the registrant internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of \$400 per hour. Additionally, we estimate that 25% of the burden of preparation for Forms 10, S-1, S-3, F-1, F-3, N-1A, N-2, and N-14 is carried by the registrant internally and that 75% of the burden of preparation is carried by outside professionals retained by the company at an average cost of \$400 per hour.

Form	Number of Estimated Affected Responses (A)	Burden Hour Reduction per Current Affected Response (B)	Reduction in Burden Hours for Current Affected Responses (C) = (A) x (B)	Reduction in Company Hours for Current Affected Responses (D) = (C) x 0.75 or 0.25	Reduction in Professional Hours for Current Affected Responses (E) = (C) x 0.25 or 0.75	Reduction in Professional Costs for Current Affected Responses (F) = (E) x \$400
10	20	(100)	(2,000)	(500)	(1,500)	(\$600,000)
1-A	18	(100)	(1,800)	(1,350)	(450)	(\$180,000)
S-1	78	(100)	(7,800)	(1,950)	(5,850)	(\$2,340,000)
S-3	192	(100)	(19,200)	(4,800)	(14,400)	(\$5,760,000)
F-1	2	(100)	(200)	(50)	(150)	(\$60,000)
F-3	3	(100)	(300)	(75)	(225)	(\$90,000)
8-K	947	(100)	(94,700)	(71,025)	(23,675)	(\$9,470,000)
Total	1,260		(126,000)	(79,750)	(46,250)	(\$18,500,000)

**Table 8: Calculation of the Change in Burden Estimates of Current Responses Due to Proposed Rule 6-11 and Amendments to Form N-14**

Form	Number of Estimated Affected Responses (A)	Burden Hour Change per Current Affected Response (B)	Change in Burden Hours for Current Affected Responses (C) = (A) x (B)	Change in Company Hours for Current Affected Responses (D) = (C) x 0.75 or 0.25	Change in Professional Hours for Current Affected Responses (E) = (C) x 0.25 or 0.75	Change in Professional Costs for Current Affected Responses (F) = (E) x \$400
N-1A	8	(100)	(800)	(200)	(600)	(\$240,000)
N-2	3	(100)	(300)	(75)	(225)	(\$90,000)
N-14	88	(100)	(8,800)	(2,200)	(6,600)	(\$2,640,000)
Total	99		(9,900)	(2,475)	(7,425)	(\$2,970,000)

**Table 9: Requested Paperwork Burden under the Proposed Amendments**

Form	Current Burden			Program Change			Requested Change in Burden		
	Current Annual Responses	Current Burden Hours	Current Cost Burden (C)	Number of Affected	Reduction in Company	Reduction in Professional Costs	Annual Responses (G)	Burden Hours (H)	Cost Burden (I)

	(A)	(B)		Responses (D) <sup>310</sup>	Hours (E) <sup>311</sup>	(F) <sup>312</sup>	= (A)	= (B) + (E)	= (C) + (F)
10	216	11,774	\$14,128,888	20	(500)	(\$600,000)	216	11,274	\$13,528,888
1-A	112	63,084	\$8,400,000	18	(1,350)	(\$180,000)	112	61,734	\$8,220,000
S-1	901	150,998	\$181,197,300	78	(1,950)	(\$2,340,000)	901	149,048	\$178,857,300
S-3	1,657	196,930	\$236,322,036	192	(4,800)	(\$5,760,000)	1,657	192,130	\$230,562,036
F-1	63	26,980	\$32,375,700	2	(50)	(\$60,000)	63	26,930	\$32,315,700
F-3	112	4,760	\$5,712,000	3	(75)	(\$90,000)	112	4,685	\$5,622,000
8-K	118,387	685,255	\$91,367,630	947	(71,025)	(\$9,470,000)	118,387	614,230	\$81,897,630
N-1A	6,002	1,596,749	\$129,338,408	8	(200)	(\$240,000)	6,002	1,596,549	\$129,098,408
N-2	166	73,250	\$4,668,396	3	(75)	(\$90,000)	166	73,175	\$4,578,396
N-14	192	97,280	\$4,498,000	88	(2,200)	(\$2,640,000)	192	95,080	\$1,858,000
Total	127,808	2,907,060	\$708,008,358	1,359	(82,225)	(\$21,470,000)	127,808	2,824,835	\$686,538,358

### Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to:

- evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- evaluate the accuracy of our assumptions and estimates of the burden of the proposed collection of information;
- determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected;
- evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and
- evaluate whether the proposed amendments would have any effects on any other

<sup>310</sup> From Table 3, Column (C) and Table 6, Column (C). The affected responses will not add to the number of annual responses; rather the requested change in burden will be averaged across all annual responses.

<sup>311</sup> From Column (D) in Tables 7 and 8.

<sup>312</sup> From Column (F) in Tables 7 and 8.

collection of information not previously identified in this section.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burdens. Persons submitting comments on the collection of information requirements should direct their comments to the Office of Management and Budget, Attention: Desk Officer for the U.S. Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy to Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549, with reference to **File No. S7-05-19**. Requests for materials submitted to OMB by the Commission with regard to the collection of information requirements should be in writing, refer to File No. **S7-05-19** and be submitted to the U.S. Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington DC 20549. OMB is required to make a decision concerning the collection of information requirements between 30 and 60 days after publication of the proposed amendments. Consequently, a comment to OMB is best assured of having its full effect if the OMB receives it within 30 days of publication.

## **VI. Small Business Regulatory Enforcement Fairness Act**

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”),<sup>313</sup> we solicit data to determine whether the proposed amendments constitute a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in:

- an annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- a major increase in costs or prices for consumers or individual industries; or

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<sup>313</sup> Pub. L. 104-121, tit. II, 110 Stat. 857 (1996).

- significant adverse effects on competition, investment, or innovation.

Commenters are requested to provide comment and empirical data on (a) the potential annual effect on the U.S. economy; (b) any increase in costs or prices for consumers or individual industries; and (c) any potential effect on competition, investment, or innovation.

## **VII. Initial Regulatory Flexibility Act Analysis**

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with the Regulatory Flexibility Act.<sup>314</sup> It relates to proposed amendments to the financial disclosure requirements in Regulation S-X relating to significant business acquisitions and dispositions to improve those requirements for both investors and registrants.

### **A. Reasons for, and Objectives of, the Proposed Action**

The proposed amendments would include changes to the requirements for the financial statements of acquisitions and dispositions of businesses, including real estate operations, in Rule 3-05 and Rule 3-14 and other related rules and forms.<sup>315</sup> We are also proposing new Rule 6-11 and amendments to Form N-14 to specifically govern financial reporting for acquisitions involving investment companies. These changes are intended to provide investors with the information that is important given the specific facts and circumstances, make the disclosures easier to understand, and reduce the costs and burdens to registrants of preparing the disclosure. The reasons for, and objectives of, the proposed amendments are discussed in more detail in Sections II.A through II.E. above.

### **B. Legal Basis**

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<sup>314</sup> 5 U.S.C. 601 *et seq.*

<sup>315</sup> We are also proposing related amendments to the definition of “significant subsidiary” in Rule 1-02(w) of Regulation S-X, Exchange Act Rule 12b-2, Securities Act Rule 405, Investment Company Act Rule 8b-2; Rule 3-06 of Regulation S-X; Article 8 of Regulation S-X; and Article 11 of Regulation S-X. In addition, we are proposing amendments to Form 8-K, Form 10-K, and Form N-2.

We are proposing the rule and form amendments contained in this release under the authority set forth in Sections 3, 6, 7, 8, 10, 19(a), and 28 of the Securities Act of 1933, as amended, Sections 3(b), 12, 13, 15(d), 23(a), and 36 of the Securities Exchange Act of 1934, as amended, and Sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act of 1940, as amended.

### **C. Small Entities Subject to the Proposed Rules**

The proposed changes would affect some registrants that are small entities. The Regulatory Flexibility Act defines “small entity” to mean “small business,” “small organization,” or “small governmental jurisdiction.”<sup>316</sup> For purposes of the Regulatory Flexibility Act, under our rules, an issuer, other than an investment company, is a “small business” or “small organization” if it had total assets of \$5 million or less on the last day of its most recent fiscal year and is engaged or proposing to engage in an offering of securities that does not exceed \$5 million.<sup>317</sup> We estimate that there are 1,173 issuers that file with the Commission, other than investment companies, that may be considered small entities and are potentially subject to the proposed amendments.<sup>318</sup> An investment company is a small entity if, together with other investment companies in the same group of related investment companies, it has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>319</sup> Commission staff estimates that, as of December 31, 2018, there were approximately 90 open-end and closed-end investment companies that would be considered small entities. Commission staff further estimates that, as

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<sup>316</sup> 5 U.S.C. 601(6).

<sup>317</sup> See 17 CFR 230.157 under the Securities Act and 17 CFR 240.0-10(a) under the Exchange Act.

<sup>318</sup> This estimate is based on staff analysis of issuers, excluding coreregistrants, with EDGAR filings of Form 10-K, 20-F and 40-F, or amendments, filed during the calendar year of January 1, 2018 to December 31st, 2018. Analysis is based on data from XBRL filings, Compustat, and Ives Group Audit Analytics.

<sup>319</sup> 17 CFR 270.0-10(a).

of December 31, 2018, approximately 16 BDCs are small entities.<sup>320</sup>

#### **D. Reporting, Recordkeeping, and Other Compliance Requirements**

As noted above, the purpose of the proposed amendments to Rules 3-05 and 3-14 is to improve the quality and relevance of financial information about acquired businesses and reduce the complexity and costs of preparing the disclosure.<sup>321</sup> We are also proposing specific regulatory requirements for investment companies to address the unique attributes of this group of registrants.<sup>322</sup>

Many of the proposed changes would simplify and streamline existing disclosure requirements in ways that are expected to reduce compliance burdens for all registrants, including small entities. The proposed changes to the pro forma financial information requirements would incrementally increase compliance costs for registrants, although we do not expect these additional costs to be significant.<sup>323</sup> In addition, compliance with the proposed amendments would require the use of professional skills, including accounting and legal skills. We discuss the economic impact, including the estimated costs and burdens, of the proposed amendments to all registrants, including small entities, in Sections IV and V above.

#### **E. Duplicative, Overlapping, or Conflicting Federal Rules**

We believe that the proposed amendments would not duplicate, overlap, or conflict with

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<sup>320</sup> These estimates are based on staff analysis of Morningstar data and data submitted by investment company registrants in forms filed on EDGAR between April 1, 2018 and June 30, 2018.

<sup>321</sup> *See supra* Sections II.A. through II.D. for a detailed discussion of the proposed amendments applicable to registrants with operations or that otherwise are not investment companies.

<sup>322</sup> *See supra* Section II.E.

<sup>323</sup> Specifically, the proposed amendment of Rule 8-05 would require that for smaller reporting companies and issuers relying on Regulation A, the preparation, presentation, and disclosure of pro forma financial information substantially comply with Article 11 rather than directing these entities to consider the requirements of Article 11. However, based on a staff analysis of 2017 disclosures of acquisitions and dispositions by smaller reporting companies, we do not expect the increase in incremental compliance costs resulting from the proposed amendment to be significant because it appears that most smaller reporting companies already comply with the conditions in existing Rule 11-01. *See supra* Section II.D.3.



other federal rules.

#### **F. Significant Alternatives**

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

- establishing different compliance or reporting requirements that take into account the resources available to small entities;
- clarifying, consolidating, or simplifying compliance and reporting requirements under the rules for small entities;
- using performance rather than design standards; and
- exempting small entities from all or part of the requirements.

The proposed amendments generally would simplify and streamline disclosure requirements in ways that are expected to reduce compliance burdens for all registrants, including small entities. Revising Rule 8-05 to require that the preparation, presentation, and disclosure of pro forma financial information by smaller reporting companies substantially comply with Article 11 may increase the burden of preparing that disclosure for some registrants. However, based on staff analysis of 2017 disclosures of acquisitions and dispositions by smaller reporting companies, we believe that most of these companies already comply with the conditions in existing Rule 11-01.<sup>324</sup> For investment companies, we believe that proposed Rule 6-11 and related amendments will make it easier and less costly to provide appropriate disclosures to investors regarding fund acquisitions, which may benefit small entities that have

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<sup>324</sup> Commission staff found that out of 191 disclosures of acquisitions and dispositions by smaller reporting companies in 2017, 178 appeared to comply with Article 11 requirements.

smaller asset levels over which to apportion compliance costs. Accordingly, we do not believe it is necessary to exempt small entities from all or part of the proposed amendments or to establish different compliance or reporting requirements for such entities. However, we are soliciting comment on whether the amendments should permit additional or different flexibility for smaller reporting companies and other types of issuers in light of the burdens associated with the financial reporting requirements.

Finally, with respect to using performance rather than design standards, Regulation S-X and the proposed amendments generally contain elements similar to performance standards. For example, rather than imposing a specific uniform metric for determining significant business acquisitions and dispositions, the proposed amendments utilize a flexible standard, with alternative tests (e.g., the investment, income, or asset test) that are intended to facilitate a registrant's determination of whether an acquisition or disposition is significant. We believe this flexible standard is appropriate because it would allow registrants to omit financial information that is not necessary for an investment decision based on the facts and circumstances applicable to that registrant and offering. We have not, however, proposed an approach that would allow registrants to determine significance based on materiality. Nevertheless, we have solicited comment throughout this release on whether a materiality standard would be appropriate for these purposes.

### **Request for Comment**

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- How the proposed rule and form amendments can achieve their objective while lowering the burden on small entities;
- The number of small entity companies that may be affected by the proposed rule and form amendments;
- The existence or nature of the potential effects of the proposed amendments on small entity companies discussed in the analysis; and
- How to quantify the effects of the proposed amendments.

Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of that effect. Comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules themselves.

### **VIII. Statutory Authority**

The amendments contained in this release are being proposed under the authority set forth in Sections 3, 6, 7, 8, 10, 19(a), and 28 of the Securities Act, Sections 3(b), 12, 13, 15(d), 23(a), and 36 of the Exchange Act, and Sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act.

#### **List of Subjects**

##### **17 CFR Part 210**

Accountants, Accounting, Banks, Banking, Employee benefit plans, Holding companies, Insurance companies, Investment companies, Oil and gas exploration, Reporting and recordkeeping requirements, Securities, Utilities.

##### **17 CFR Part 230**

Investment companies, Reporting and recordkeeping requirements, Securities.

**17 CFR Part 239**

Reporting and recordkeeping requirements, Securities.

**17 CFR Part 240**

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

**17 CFR Part 249**

Brokers, Reporting and recordkeeping requirements, Securities.

**17 CFR Parts 270 and 274**

Investment companies, Reporting and recordkeeping requirements, Securities.

**TEXT OF THE PROPOSED AMENDMENTS**

For the reasons set out in the preamble, the Commission is proposing to amend title 17, chapter II of the Code of Federal Regulations as follows:

**PART 210 – FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975**

- 1. The authority citation for part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, and sec. 102(c), Pub. L. 112-106, 126 Stat. 310 (2012), unless otherwise noted.

- 2. Revise § 210.1-02(w) to read as follows:

**§ 210.1-02 Definitions of terms used in Regulation S-X (17 CFR part 210).**

\* \* \* \* \*

(w) *Significant subsidiary.* (1) The term *significant subsidiary* means a subsidiary, including its subsidiaries, which meets any of the conditions in paragraphs (w)(1)(i), (w)(1)(ii),

or (w)(1)(iii) of this section; however if the subsidiary is a registered investment company or a business development company, it meets any of the conditions in paragraph (w)(2) of this section instead of any of the conditions in this paragraph (w)(1). A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles (U.S. GAAP) shall use amounts determined under U.S. GAAP. A foreign private issuer that files its financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) shall use amounts determined under IFRS-IASB.

(i) *Investment Test.* (A) The registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the aggregate worldwide market value of the registrant's voting and non-voting common equity, or if the registrant has no such aggregate worldwide market value the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year. Aggregate worldwide market value of the registrant's voting and non-voting common equity shall be determined as of the last business day of the registrant's most recently completed fiscal year, which for acquisitions and dispositions shall be at or prior to the date of acquisition or disposition;

(B) For a combination between entities or businesses under common control, this test shall be met when either the net book value of the tested subsidiary exceeds 10 percent of the registrant's and its subsidiaries' consolidated total assets or the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated;

(C) For all other acquisitions, the "investment in" the tested subsidiary shall include the fair value of contingent consideration if required to be recognized at fair value by the registrant

at the acquisition date under U.S. GAAP or IFRS-IASB, as applicable; however if recognition at fair value is not required, include all contingent consideration, except sales-based milestones and royalties, unless the likelihood of payment is remote. The “investment in” the tested subsidiary also excludes the registrant’s and its subsidiaries’ proportionate interest in the carrying value of assets transferred by the registrant and its subsidiaries consolidated to the tested subsidiary that will remain with the combined entity after the acquisition; and

(D) For dispositions, the “investment in” the tested subsidiary shall equal the fair value of the consideration, which shall include contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant or, when the registrant has no such aggregate worldwide market value, the carrying value of the disposed subsidiary when comparing to total assets of the registrant. For a real estate operation as defined in § 210.3-14(a)(2), when the investment test is based on the total assets of the registrant and its subsidiaries consolidated, include any debt secured by the real properties that is assumed by the buyer in the “investment in” the tested real estate operation.

(ii) *Asset Test.* The registrant’s and its other subsidiaries’ proportionate share of the total assets (after intercompany eliminations) of the tested subsidiary exceeds 10 percent of such total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(iii) *Income Test.* (A)(1) The absolute value of the registrant’s and its other subsidiaries’ equity in the tested subsidiary’s consolidated income or loss from continuing operations (after intercompany eliminations) attributable to the controlling interests exceeds 10 percent of the absolute value of such income or loss of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; and

(2) The registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenue (after intercompany eliminations) exceeds 10 percent of such total revenue of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. This component does not apply if either the registrant and its subsidiaries consolidated or the tested subsidiary does not have recurring annual revenue.

(B) When determining the income component in paragraph (w)(1)(iii)(A)(1) of this section:

(1) If a net loss from continuing operations attributable to the controlling interest has been incurred by either the registrant and its subsidiaries consolidated or the tested subsidiary, but not both, exclude the equity in the income or loss from continuing operations of the tested subsidiary attributable to the controlling interest from such income or loss of the registrant and its subsidiaries consolidated for purposes of the computation;

(2) Compute the test using the average described herein if the revenue component in paragraph (w)(1)(iii)(A)(2) does not apply and the absolute value of the registrant's and its consolidated subsidiaries' income or loss from continuing operations attributable to the controlling interests for the most recent fiscal year is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years; and

(3) Entities reporting losses shall not be aggregated with entities reporting income where the test involves combined entities, as in the case of determining whether summarized financial data should be presented, except when determining whether related businesses meet this test for purposes of §§210.3-05 and 210.8-04.

(2) For a registrant that is a registered investment company or a business development company, the term *significant subsidiary* means a subsidiary, including its subsidiaries, which

meets any of the following conditions using amounts determined under U.S. GAAP and, if applicable, section 2(a)(41) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(41)):

(i) *Investment Test*. The value of the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

(ii) *Income Test*. The absolute value of the combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary, for the most recently completed fiscal year exceeds:

(A) 80 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; or

(B) 10 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year and the Investment Test (paragraph (w)(2)(i) of this section) condition exceeds 5 percent. However, if the registrant and its subsidiaries consolidated has an insignificant change in net assets resulting from operations for its most recently completed fiscal year, 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.

\* \* \* \* \*

3. Revise § 210.3-05 to read as follows:

**§ 210.3-05 Financial statements of businesses acquired or to be acquired.**

(a) *Financial statements required*. (1) Financial statements (except the related schedules



specified in § 210.12) prepared and audited in accordance with this regulation (including the independence standards in § 210.2-01 or, alternatively if the business is not a registrant, the applicable independence standards) shall be filed for the periods specified in paragraph (b) of this section if any of the following conditions exist:

(i) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by § 210.3-01, a business acquisition has occurred; or

(ii) After the date of the most recent balance sheet filed pursuant to § 210.3-01, consummation of a business acquisition has occurred or is probable.

(2) For purposes of determining whether the provisions of this rule apply:

(i) The determination of whether a *business* has been acquired should be made in accordance with the guidance set forth in § 210.11-01(d); and

(ii) The acquisition of a business encompasses the acquisition of an interest in a business accounted for by the registrant under the equity method or, in lieu of the equity method, the fair value option.

(3) Acquisitions of a group of related businesses that are probable or that have occurred subsequent to the latest fiscal year-end for which audited financial statements of the registrant have been filed shall be treated under this section as if they are a single business acquisition.

The required financial statements of related businesses may be presented on a combined basis for any periods they are under common control or management. For purposes of this section, businesses shall be deemed to be related if:

(i) They are under common control or management;

(ii) The acquisition of one business is conditional on the acquisition of each other business; or

(iii) Each acquisition is conditioned on a single common event.

(4) This rule shall not apply to a real estate operation subject to § 210.3-14 or a business which is totally held by the registrant prior to consummation of the transaction.

(b) *Periods to be presented.* (1) If securities are being registered to be offered to the security holders of the business to be acquired, the financial statements specified in §§ 210.3-01 and 210.3-02 shall be filed for the business to be acquired, except as provided otherwise for filings on Form N-14, S-4, or F-4 (§ 239.23, § 239.25, or § 239.34 of this chapter). The financial statements covering fiscal years shall be audited except as provided in Item 14 of Schedule 14A (§ 240.14a-101 of this chapter) with respect to certain proxy statements or in registration statements filed on Forms N-14, S-4, or F-4 (§ 239.23, § 239.25, or § 239.34 of this chapter).

(2) In all cases not specified in paragraph (b)(1) of this section, financial statements of the business acquired or to be acquired shall be filed for the periods specified in this paragraph (b)(2) or such shorter period as the business has been in existence. The periods for which such financial statements are to be filed shall be determined using the conditions specified in the definition of significant subsidiary in § 210.1-02(w), using the lower of the total revenue component or income or loss from continuing operations component for evaluating the income test condition, as follows:

(i) If none of the conditions exceeds 20 percent, financial statements are not required.

(ii) If any of the conditions exceeds 20 percent, but none exceed 40 percent, financial statements shall be filed for at least the most recent fiscal year and the most recent interim period specified in §§ 210.3-01 and 210.3-02.

(iii) If any of the conditions exceeds 40 percent, financial statements shall be filed for at least the two most recent fiscal years and any interim periods specified in §§ 210.3-01 and 210.3-

02.

(iv) If the aggregate impact of businesses acquired or to be acquired since the date of the most recent audited balance sheet filed for the registrant, for which financial statements are either not required by paragraph (b)(2)(i) of this section or are not yet required based on paragraph (b)(4)(i) of this section, exceeds 50 percent, the registrant shall provide:

(A) Pro forma financial information pursuant to §§ 210.11-01 through 210.11-02 that depicts the aggregate impact of these acquired or to be acquired businesses in all material respects; and

(B) Financial statements covering at least the most recent fiscal year and the most recent interim period specified in §§ 210.3-01 and 210.3-02 for any acquired or to be acquired business for which financial statements are not yet required based on paragraph (b)(4)(i) of this section.

(3) The determination shall be made using § 210.11-01(b)(3).

(4) Financial statements required for the periods specified in paragraph (b)(2) of this section may be omitted to the extent specified as follows:

(i) Registration statements not subject to the provisions of § 230.419 of this chapter and proxy statements need not include separate financial statements of an acquired or to be acquired business if neither the business nor the aggregate impact specified in paragraph (b)(2)(iv) of this section exceeds any of the conditions of significance in the definition of significant subsidiary in § 210.1-02 at the 50 percent level computed in accordance with paragraph (b)(3) of this section, and either:

(A) The consummation of the acquisition has not yet occurred; or

(B) The date of the final prospectus or prospectus supplement relating to an offering as filed with the Commission pursuant to § 230.424(b) of this chapter, or mailing date in the case of

a proxy statement, is no more than 74 days after consummation of the business acquisition, and the financial statements have not previously been filed by the registrant.

(ii) A registrant, other than a foreign private issuer required to file reports on Form 6-K (§ 249.306 of this chapter), that omits from its initial registration statement financial statements of a recently consummated business acquisition pursuant to paragraph (b)(4)(i) of this section shall file those financial statements and any pro forma information specified by Article 11 under cover of Form 8-K (§ 249.308 of this chapter) no later than 75 days after consummation of the acquisition.

(iii) Separate financial statements of the acquired business need not be presented 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.

(iv) A separate audited balance sheet of the acquired business is not required when the registrant's most recent audited balance sheet required by § 210.3-01 is for a date after the date the acquisition was consummated.

(c) *Financial statements of a foreign business.* If the business acquired or to be acquired is a foreign business, financial statements of the business meeting the requirements of Item 17 of Form 20-F (§ 249.220f of this chapter) will satisfy this section. If such financial statements are prepared according to a comprehensive body of accounting principles other than those generally accepted in the United States (U.S. GAAP) or International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB), they may be reconciled to IFRS-IASB, rather than U.S. GAAP, if the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB. The reconciliation to IFRS-IASB shall generally follow the form and content requirements in Item 17(c) of Form 20-F.

(d) *Financial statements of an acquired or to be acquired business that would be a foreign private issuer if it were a registrant.* If the acquired or to be acquired business is not a foreign business (as defined in § 210.1-02(1)), but would qualify as a foreign private issuer (as defined in § 230.405 and § 240.3b-4) if it were a registrant, financial statements of the business may be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP.

(e) *Financial statements for net assets that constitute a business.* For an acquisition of net assets that constitutes a business (e.g., an acquired product line), the financial statements prepared and audited in accordance with this regulation may be statements of assets acquired and liabilities assumed and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) if the following conditions are met:

(1) 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;

(2) Separate financial statements for the business have not previously been prepared;

(3) 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;

(4) 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;

(5) 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

(6) The notes to the financial statements include the following disclosures:

(i) The type of omitted expenses and the reason(s) why they are excluded from the financial statements.

(ii) An explanation of the impracticability of preparing financial statements that include the omitted expenses.

(iii) A description of how the financial statements presented are not indicative of the financial condition or results of operations of the acquired business going forward because of the omitted expenses.

(iv) Information about the business's operating, investing and financing cash flows, to the extent available.

(f) *Financial statements of a business that includes oil and gas producing activities.* (1) If the acquisition constitutes a business that includes *significant oil- and gas-producing activities* (as defined in the FASB ASC Master Glossary), the disclosures in FASB ASC Topic 932 *Extractive Activities – Oil and Gas*, 932-235-50-3 through 50-11 and 932-235-50-29 through 50-36, which may be presented as unaudited supplemental information, shall be provided for each full year of operations presented for the acquired business. If prior year reserve studies were not made, they may be computed using only production and new discovery quantities and valuation, in which case there will be no “revision of prior estimates” amounts. Registrants may develop these disclosures based on a reserve study for the most recent year, computing the changes backward if the method of computation is disclosed in a footnote.

(2) Financial statements prepared and audited in accordance with this regulation may be limited to audited statements of revenues and expenses that exclude depletion, depreciation, and amortization expense, corporate overhead expense, income taxes, and interest expense that are not comparable to the proposed future operations if:

(i) The acquisition generates substantially all of its revenues from *oil and gas producing activities* (as defined in §210.4-10(a)(16)); and

(ii) The conditions specified in paragraph (e)(1) through (e)(4) and (e)(6) of this section are met.

4. Revise § 210.3-06 to read as follows:

**§ 210.3-06 Financial statements covering a period of nine to twelve months.**

(a) Except with respect to registered investment companies, the filing of financial statements covering a period of 9 to 12 months shall be deemed to satisfy a requirement for filing financial statements for a period of 1 year where:

(1) The issuer has changed its fiscal year;

(2) The issuer has made a significant business acquisition for which financial statements are required under §210.3-05, §210.3-14, §210.8-04, or §210.8-06 of this chapter and the financial statements covering the interim period pertain to the business being acquired; or

(3) The Commission so permits pursuant to §210.3-13 or Note 5 to §210.8 of this chapter.

(b) Where there is a requirement for filing financial statements for a time period exceeding one year but not exceeding three consecutive years (with not more than 12 months included in any period reported upon), the filing of financial statements covering a period of 9 to 12 months shall satisfy a filing requirement of financial statements for one year of that time period only if the conditions described in paragraphs (a)(1), (2) or (3) of this section exist and financial statements are filed that cover the full fiscal year or years for all other years in the time period.

5. Revise § 210.3-14 to read as follows:

**§ 210.3-14 Special instructions for financial statements of real estate operations acquired or to be acquired.**

(a) *Financial statements required.* (1) Financial statements (except the related schedules specified in § 210.12) prepared and audited in accordance with Regulation S-X (including the independence standards in § 210.2-01 or, alternatively if the business is not a registrant, the applicable independence standards) for the periods specified in paragraph (b) of this section and the supplemental information specified in paragraph (f) of this section shall be filed if any of the following conditions exist:

(i) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by § 210.3-01, an acquisition of a real estate operation has occurred; or

(ii) After the date of the most recent balance sheet filed pursuant to § 210.3-01, consummation of an acquisition of a real estate operation has occurred or is probable.

(2) For purposes of determining whether the provisions of this rule apply:

(i) The term *real estate operation* means a business (as set forth in § 210.11-01(d)) that generates substantially all of its revenues through the leasing of real property.

(ii) The acquisition of a real estate operation encompasses the acquisition of an interest in a real estate operation accounted for by the registrant under the equity method or, in lieu of the equity method, the fair value option.

(3) Acquisitions of a group of related real estate operations that are probable or that have occurred subsequent to the latest fiscal year-end for which audited financial statements of the registrant have been filed shall be treated under this section as if they are a single acquisition. The required financial statements may be presented on a combined basis for any periods they are under common control or management. For purposes of this section, acquisitions shall be



deemed to be related if:

(i) They are under common control or management;

(ii) The acquisition of one real estate operation is conditional on the acquisition of each other real estate operation; or

(iii) Each acquisition is conditioned on a single common event.

(4) This rule shall not apply to a real estate operation that is totally held by the registrant prior to consummation of the transaction.

(b) *Periods to be presented.* (1) If securities are being registered to be offered to the security holders of the real estate operation to be acquired, the financial statements specified in paragraph (c) of this section and the supplemental information specified in paragraph (f) of this section shall be filed for the real estate operation to be acquired for the periods specified in §§ 210.3-01 and 210.3-02, except as provided otherwise for filings on Form S-4 or F-4 (§ 239.25 or § 239.34 of this chapter). The financial statements covering fiscal years shall be audited except as provided in Item 14 of Schedule 14A (§ 240.14a-101 of this chapter) with respect to certain proxy statements or in registration statements filed on Forms S-4 or F-4 (§ 239.25 or § 239.34 of this chapter).

(2) In all cases not specified in paragraph (b)(1) of this section, financial statements of the real estate operation acquired or to be acquired shall be filed for the periods specified in this paragraph (b)(2) or such shorter period as the real estate operation has been in existence. The periods for which such financial statements are to be filed shall be determined using the condition specified in the definition of significant subsidiary in § 210.1-02(w)(1)(i) modified as follows:

(i)(A) If the condition does not exceed 20 percent, financial statements are not required.

(B) If the condition exceeds 20 percent, financial statements of the real estate operation for at least the most recent fiscal year and the most recent interim period specified in §§ 210.3-01 and 210.3-02 shall be filed.

(C) If the aggregate impact of acquired or to be acquired real estate operations since the date of the most recent audited balance sheet filed for the registrant, for which financial statements are either not required by paragraph (b)(2)(i)(A) of this section or are not yet required based on paragraph (b)(3)(i), exceeds 50 percent, the registrant shall provide:

(1) Pro forma financial information pursuant to §§ 210.11-01 through 210.11-02 that depicts the aggregate impact of these acquired or to be acquired real estate operations in all material respects; and

(2) Financial statements covering at least the most recent fiscal year and the most recent interim period specified in §§ 210.3-01 and 210.3-02 for any acquired or to be acquired real estate operation for which financial statements are not yet required based on paragraph (b)(3)(i) of this section.

(i) When the investment test is based on the total assets of the registrant and its subsidiaries consolidated, include any assumed debt secured by the real properties in the “investment in” the tested real estate operation.

(iii) Determine total assets as of the end of the most recently completed fiscal year included in the registrant’s most recent consolidated financial statements filed at or prior to the date of acquisition; however, the determination may be made using § 210.11-01(b)(3)(i) and §210.11-01(b)(3)(ii). When a registrant, including a real estate investment trust, conducts a continuous offering over an extended period of time and applies the Item 20.D Undertakings of Industry Guide 5, use the following instead:

(A) During the distribution period, determine total assets as of the date of acquisition plus the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months; and

(B) After the distribution period ends and until the next Form 10-K is filed, determine total assets as of the date of acquisition; and

(C) After that next Form 10-K is filed, determine total assets as of the end of the most recently completed fiscal year included in the Form 10-K. However, the determination may be made using §210.11-01(b)(3)(i) and §210.11-01(b)(3)(ii).

(3) Financial statements required for the periods specified in paragraph (b)(2) of this section may be omitted to the extent specified as follows:

(i) Registration statements not subject to the provisions of § 230.419 of this chapter and proxy statements need not include separate financial statements of the acquired or to be acquired real estate operation if neither the real estate operation nor the aggregate impact specified in (b)(2)(i)(C) of this section exceeds the condition of significance in the definition of significant subsidiary in § 210.1-02(w)(1)(i), as modified by paragraphs (b)(2)(ii) and (iii) of this section, at the 50 percent level computed in accordance with paragraph (b)(2) of this section, and either:

(A) The consummation of the acquisition has not yet occurred; or

(B) The date of the final prospectus or prospectus supplement relating to an offering as filed with the Commission pursuant to § 230.424(b) of this chapter, or mailing date in the case of a proxy statement, is no more than 74 days after consummation of the acquisition of the real estate operation, and the financial statements have not previously been filed by the registrant.

(ii) A registrant, other than a foreign private issuer required to file reports on Form 6-K (§ 249.306 of this chapter), that omits from its initial registration statement financial statements of a

recently consummated acquisition of a real estate operation pursuant to paragraph (b)(3)(i) of this section shall file those financial statements and any pro forma information specified by §§ 210.11-01 to 210.11.03 (Article 11) of this chapter under cover of Form 8-K (§ 249.308 of this chapter) no later than 75 days after consummation of the acquisition.

(iii) Separate financial statements of the acquired real estate operation need not be presented once the operating results of the acquired real estate operation have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year.

(c) *Presentation of the financial statements.* (1) The financial statements prepared and audited in accordance with this regulation may be only statements of revenues and expenses excluding expenses not comparable to the proposed future operations such as mortgage interest, leasehold rental, depreciation, amortization, corporate overhead and income taxes.

(2) The notes to the financial statements shall include the following disclosures:

(i) The type of omitted expenses and the reason(s) why they are excluded from the financial statements;

(ii) A description of how the financial statements presented are not indicative of the results of operations of the acquired real estate operation going forward because of the omitted expenses; and

(iii) Information about the real estate operation's operating, investing and financing cash flows, to the extent available.

(d) *Financial statements of foreign business.* If the real estate operation acquired or to be acquired is a foreign business, financial statements of the real estate operation specified in paragraph (c) of this section meeting the requirements of Item 17 of Form 20-F (§ 249.220f of this chapter) will satisfy this section. If such financial statements are prepared according to a

comprehensive body of accounting principles other than those generally accepted in the United States (U.S. GAAP) or International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB), they may be reconciled to IFRS-IASB, rather than U.S. GAAP, if the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB. The reconciliation to IFRS-IASB shall generally follow the form and content requirements in Item 17(c) of Form 20-F.

(e) *Financial statements of an acquired or to be acquired real estate operation that would be a foreign private issuer if it were a registrant.* If the acquired or to be acquired real estate operation is not a foreign business (as defined in § 210.1-02(l)), but would qualify as a foreign private issuer (as defined in § 230.405 and § 240.3b-4) if it were a registrant, financial statements of the real estate operation specified in paragraph (c) of this section may be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP.

(f) *Supplemental information.* For each real estate operation for which financial statements are required to be filed by paragraphs (b)(2)(i)(B) and (b)(2)(i)(C)(2), material factors considered by the registrant in assessing the real estate operation must be described with specificity in the filing, including sources of revenue (including, but not limited to, competition in the rental market, comparative rents, and occupancy rates) and expense (including, but not limited to, utility rates, property tax rates, maintenance expenses, and capital improvements anticipated). The disclosure must also indicate that the registrant is not aware of any other material factors relating to the specific real estate operation that would cause the reported financial statements not to be indicative of future operating results.

INSTRUCTION TO PARAGRAPH (f): When the financial statements are presented in Form S-11 (§ 239.18 of this chapter), the discussion of material factors considered should supplement the

disclosures required by Item 15 of Form S-11.

§ 210.3-18 [Amended]

6. Amend § 210.3-18(d) by removing the phrase “§§ 210.6-01 to 210.6-10” and adding in its place “§§ 210.6-01 to 210.6-11”.

§ 210.5-01 [Amended]

7. Amend § 210.5-01(a) by removing the phrase “§§ 210.6-01 to 210.6-10” and adding in its place “§§ 210.6-01 to 210.6-11”.

§ 210.6-01 [Amended]

8. Amend § 210.6-01 by removing the phrases “§§ 210.6-01 to 210.6-10” in the title and in the rule text and adding in each place “§§ 210.6-01 to 210.6-11”.

§ 210.6-02 [Amended]

9. Amend § 210.6-02(b) and (c) by removing the phrases “§§ 210.6-01 to 210.6-10” and adding in each place “§§ 210.6-01 to 210.6-11”.

§ 210.6-03 [Amended]

10. Amend § 210.6-03 by removing the phrase “§§ 210.6-01 to 210.6-10” in the introductory text and paragraph (a) and adding in each place “§§ 210.6-01 to 210.6-11”.

11. Add § 210.6-11 to read as follows:

**§ 210.6-11 Financial statements of funds acquired or to be acquired.**

(a) *Financial statements required.* (1) Financial statements, including the schedules specified in §§ 210.12-01 to 210.12-29 (Article 12), prepared and audited in accordance with this regulation (including the independence standards in § 210.2-01 or, alternatively if the fund is not a registrant, the applicable independence standards) for the periods specified in paragraph (b) of

this section and the supplemental information specified in paragraph (d) of this section shall be filed if any of the following conditions exist:

(i) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by §§ 210.3-01 or 210.3-18, a fund acquisition has occurred; or

(ii) After the date of the most recent balance sheet filed pursuant to §§ 210.3-01 or 210.3-18 or, if no relevant balance sheet has been filed in connection with a post-effective amendment for a new series submitted pursuant to Rule 485(a)(2) under the Securities Act (§ 230.485(a)(2) of this chapter), the filing of such amendment, consummation of a fund acquisition has occurred or is probable.

(2) For purposes of this section:

(i) The term *fund* includes any investment company as defined in section 3(a) of the Investment Company Act of 1940, including a business development company, or any company that would be an investment company but for the exclusions provided by sections 3(c)(1) or 3(c)(7) of that Act, or any private account managed by an investment adviser.

(ii) The determination of whether a fund has been acquired or will be acquired should be evaluated in light of the facts and circumstances involved. A fund acquisition includes the acquisition by the registrant of all or substantially all of the portfolio investments held by another fund or an acquisition of a fund's portfolio investments that will constitute all or substantially all of the initial assets of the registrant.

(3) Acquisitions of a group of related funds that are probable or that have occurred subsequent to the latest fiscal year-end for which audited financial statements of the registrant have been filed shall be treated under this section as if they are a single acquisition. The required financial statements may be presented either on an individual or a combined basis for any

periods they are under common control or management. For purposes of this section, funds shall be deemed to be related if:

- (i) They are under common control or management;
- (ii) The acquisition of one fund is conditional on the acquisition of each other fund; or
- (iii) Each acquisition is conditioned on a single common event.

(4) This rule shall not apply to a fund which is totally held by the registrant prior to consummation of the transaction.

(b) *Periods to be presented.* (1) If securities are being registered to be offered to the security holders of the fund to be acquired, the financial statements specified in §§ 210.3-01 and 210.3-02 or § 210.3-18, for the fund to be acquired and the supplemental information specified in paragraph (d) shall be filed, except as provided otherwise for filings on Form N-14 (§ 239.23 of this chapter). The financial statements covering the fiscal year shall be audited except as provided in Item 14 of Schedule 14A (§ 240.14a-101 of this chapter) with respect to certain proxy statements or in registration statements filed on Forms N-14 (§ 239.23 of this chapter).

(2) In all cases not specified in paragraph (b)(1) of this section, financial statements of the fund acquired or to be acquired for the periods specified in this paragraph (b)(2) or such shorter period as the fund has been in existence and the supplemental information specified in paragraph (d) of this section shall be filed. Whether such financial statements and supplemental information are to be filed shall be determined using the conditions specified in the definition of significant subsidiary in §§ 210.1-02(w)(2)(i) and (ii)(B) as follows:

(i) If none of the conditions set forth in § 210.1-02(w)(2)(i) and (ii)(B), substituting 20 percent for 10 percent each place it appears therein, are satisfied, the financial statements and supplemental financial information in paragraph (d) of this section are not required.



(ii) If any of the conditions set forth in § 210.1-02(w)(2)(i) and (ii)(B), substituting 20 percent for 10 percent each place it appears therein, are satisfied, the financial statements of the acquired fund for the most recent fiscal year and the most recent interim period shall be filed. The registrant shall also provide the supplemental financial information in paragraph (d) of this section.

(iii) If the aggregate impact of funds acquired or to be acquired since the date of the most recent audited balance sheet filed for the registrant, for which financial statements are not required by paragraph (b)(2)(i) of this section, satisfies any of the conditions set forth in § 210.1-02(w)(2)(i) and (ii)(B), substituting 50 percent for 10 percent each place it appears therein, the registrant shall provide financial statements for at least the most recent fiscal year and the most recent interim period specified in §§ 210.3-01 and 210.3-02, or § 210.3-18, for any fund acquired or to be acquired for which financial statements are not yet required by paragraph (b)(2)(i) of this section. The registrant shall also provide the supplemental financial information in paragraph (d) of this section for such funds.

(3) The determination shall be made by comparing the most recent annual financial statement of each such fund, or for acquisitions each group of related funds on a combined basis, to the registrant's most recent annual financial statements filed at or prior to the date of acquisition. However, the determination may be made by using pro forma amounts as calculated by the registrant for the periods specified in § 210.1-02(w)(2) that only give effect to an acquisition consummated after the latest fiscal year-end for which the registrant's financial statements are required to be filed when the registrant has filed audited financial statements of such acquired fund and provided the supplemental financial information for the periods required by this section.

(4) Separate financial statements of the acquired fund need not be presented after the portfolio investments of the acquired fund have been reflected in the registrant's most recent audited balance sheet required by §§ 210.3-01 or 3-18 for a date after the date the acquisition was consummated.

(c) *Presentation of financial statements.* If the fund to be acquired would be an investment company under the Investment Company Act but for the exclusion provided from that definition by either sections 3(c)(1) or 3(c)(7) of that Act, then the required financial statements shall comply with U.S. Generally Accepted Accounting Principles and only Article 12 of this part. In situations of any private account managed by an investment adviser provide the schedules specified in Article 12 of this part for the assets to be acquired.

(d) *Supplemental financial information.* (1) Supplemental financial information shall consist of:

(i) a table showing the current fees for the registrant and the acquired fund and pro forma fees, if different, for the registrant after giving effect to the acquisition using the format prescribed in the appropriate registration statement under the Investment Company Act;

(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 reflect such change and accompanied by narrative disclosure describing the change; and

(iii) narrative disclosure about material differences in financial and operating policies of the acquired fund when compared to the registrant.

(2) With respect to any fund acquisition, registered investment companies and business development companies shall provide the supplemental financial information required in this

section in lieu of any pro forma financial information required by §§ 210.11-01 to 210.11-03 of this regulation.

12. Amend § 210.8-01 by revising NOTE 2 to § 210.8 to remove the undesignated paragraph following paragraph (c) to NOTE 2, and adding NOTE 6 to § 210.8 to read as follows:

**§ 210.8-01 Preliminary Notes to Article 8.**

\* \* \* \* \*

NOTE 6 TO § 210.8: Section 210.3-06 shall apply to the preparation of financial statements of smaller reporting companies.

**§ 210.8-03 [Amended]**

13. Remove and reserve § 210.8-03(b)(4).

14. Revise § 210.8-04 to read as follows:

**§ 210.8-04 Financial statements of businesses acquired or to be acquired.**

Apply § 210.3-05 substituting §§ 210.8-02 and 210.8-03, as applicable, wherever §210.3-05 references §§ 210.3-01 and 210.3-02.

15. Revise § 210.8-05 to read as follows:

**§ 210.8-05 Pro forma financial information.**

(a) Pro forma financial information shall be disclosed when any of the conditions in § 210.11-01 exist.

(b) The preparation, presentation and disclosure of pro forma financial information shall comply with §§ 210.11-01 through 210.11-03 (Article 11), except that the pro forma financial information may be condensed pursuant to § 210.8-03(a).

16. Revise § 210.8-06 to read as follows:

**§ 210.8-06 Real estate operations acquired or to be acquired.**

Apply § 210.3-14 substituting §§ 210.8-02 and 210.8-03, as applicable, wherever § 210.3-14 references §§ 210.3-01 and 210.3-02.

17. Amend § 210.11-01 by:

- a. Removing and reserving (a)(5);
- b. Revising the introductory text of paragraph (a), and paragraphs (a)(1), (a)(2), (a)(6), (a)(8), (b), and (c) to read as follows: ;

**§ 210.11-01 Presentation requirements.**

(a) Pro forma financial information shall be filed when any of the following conditions exist:

(1) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by § 210.3-01, a significant business acquisition has occurred (for purposes of these rules, this encompasses the acquisition of an interest in a business accounted for by the equity method);

(2) After the date of the most recent balance sheet filed pursuant to § 210.3-01, consummation of a significant business acquisition or a combination of entities under common control has occurred or is probable;

\* \* \* \* \*

(5) [Reserved];

(6) Pro forma financial information required by § 229.914 is required to be provided in connection with a roll-up transaction as defined in § 229.901(c);

\* \* \* \* \*

(8) Consummation of other transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors.

(b) A business acquisition or disposition shall be considered significant if:

(1) The business acquisition meets:

(i) The definition of a significant subsidiary in § 210.1-02(w)(1), substituting 20 percent for 10 percent each place it appears therein; or

(ii) If the business is a real estate operation as defined in § 210.3-14(a)(2), the significant subsidiary condition in § 210.1-02(w)(1)(i), substituting 20 percent for 10 percent, as modified by the guidance in § 210.3-14(b)(2).

(2) The business disposition, including a business that is a real estate operation as defined in § 210.3-14(a)(2), meets the definition of a significant subsidiary in § 210.1-02(w)(1), substituting 20 percent for 10 percent each place it appears therein.

(3) The determination shall be made by comparing the most recent annual financial statements of each such business, or for acquisitions each group of related businesses (as defined in § 210.3-05(a)(3)) on a combined basis or each group of related real estate operations (as defined in § 210.3-14(a)(2)) on a combined basis, to the registrant's most recent annual consolidated financial statements filed at or prior to the date of acquisition or disposition, except as noted in § 210.3-14(b)(2)(iii) for real estate operations. Registrants that acquire net assets that constitute a business or a business that includes oil- or gas- producing activities may make the determination using the financial statements described in § 210.3-05(e) or § 210.3-05(f) if the business meets the conditions for presenting those financial statements. However, the determination may be made using:

(i) Pro forma amounts specified in § 210.11-02(a)(6)(i) for the registrant for the periods

specified in §210.11-01(b)(3) that only depict significant business acquisitions and dispositions consummated after the latest fiscal year-end for which the registrant’s financial statements are required to be filed, provided that the registrant has filed audited financial statements for any such acquired business for the periods required by § 210.3-05 or § 210.3-14 and the pro forma financial information required by § 210.11-01 through § 210.11-02 for any such acquired or disposed business. The tests may not be made by “annualizing” data; or

(ii) The registrant’s annual consolidated financial statements, for the most recent fiscal year ended prior to the acquisition or disposition, that are included in the registrant’s Form 10-K (§ 249.310 of this chapter) filed after the acquisition or disposition, but before the date financial statements and pro forma financial information for the acquisition or disposition would be required to be filed on Form 8-K (§ 249.308 of this chapter).

(c) The pro forma effects of a business acquisition need not be presented pursuant to this section if separate financial statements of the acquired business are not included in the filing, except where the aggregate impact of businesses acquired or to be acquired is significant as determined by §§ 210.3-05(b)(2)(iv) or 210.3-14(b)(2)(i)(C).

\* \* \* \* \*

18. Revise § 210.11-02 to read as follows:

**§ 210.11-02 Preparation requirements.**

(a) *Form and content.* (1) Pro forma financial information shall consist of a pro forma condensed balance sheet, pro forma condensed statements of comprehensive income, and accompanying explanatory notes. In certain circumstances (i.e., where a limited number of pro forma adjustments are required and those adjustments are easily understood), a narrative description of the pro forma effects of the transaction may be disclosed in lieu of the statements

described herein.

(2) The pro forma financial information shall be accompanied by an introductory paragraph which briefly sets forth a description of:

- (i) Each transaction for which pro forma effect is being given;
- (ii) The entities involved;
- (iii) The periods for which the pro forma financial information is presented; and
- (iv) An explanation of what the pro forma presentation shows.

(3) The pro forma condensed financial information need only include major captions (i.e., the numbered captions) prescribed by the applicable sections of Regulation S-X. Where any major balance sheet caption is less than 10 percent of total assets, the caption may be combined with others. When any major statement of comprehensive income caption is less than 15 percent of average net income attributable to the registrant for the most recent three fiscal years, the caption may be combined with others. In calculating average net income attributable to the registrant, loss years should be excluded unless losses were incurred in each of the most recent three years, in which case the average loss shall be used for purposes of this test.

Notwithstanding these tests, *de minimis* amounts need not be shown separately.

(4) Pro forma statements shall ordinarily be in columnar form showing condensed historical statements, pro forma adjustments, and the pro forma results.

(5) The pro forma condensed statement of comprehensive income shall disclose income (loss) from continuing operations and income or loss from continuing operations attributable to the controlling interest.

(6) The pro forma condensed balance sheet and pro forma condensed statements of comprehensive income shall present in separate columns and shall include, and be limited to, the

following pro forma adjustments:

(i) *Transaction Accounting Adjustments.* (A) Adjustments that depict in the pro forma condensed balance sheet the accounting for the transaction required by U.S. Generally Accepted Accounting Principles (U.S. GAAP) or, as applicable, International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB). Calculate pro forma adjustments using the measurement date and method prescribed by the applicable accounting standards. For a probable transaction, calculate pro forma adjustments using, and disclose, the most recent practicable date prior to the effective date (for registration statements) or the mail date (for proxy statements).

(B) Adjustments that depict in the pro forma condensed statements of comprehensive income the effects of the pro forma balance sheet adjustments in paragraph (a)(6)(i)(A) of this section assuming those adjustments were made as of the beginning of the fiscal year presented. If the condition in § 210.11-01(a) that is met does not have a balance sheet effect, then depict the accounting for the transaction required by U.S. GAAP or IFRS-IASB, as applicable.

(ii) *Management's Adjustments.* Management's Adjustments shall be limited to adjustments that:

(A) Give effect to reasonably estimable synergies and other transaction effects, such as closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements, that have occurred or are reasonably expected to occur.

(B) Show the registrant as an autonomous entity if the condition in § 210.11-01(a)(7) is met.

INSTRUCTION TO PARAGRAPH (a)(6)(ii) Any forward-looking information supplied is expressly covered by the safe harbor rule. See § 230.175 and § 240.3b-6 of this chapter.



(7) All pro forma adjustments should be referenced to notes that clearly explain the assumptions involved. When Management's Adjustments are presented, the pro forma condensed statements of comprehensive income shall include a separate subtotal column that combines the historical statements and the Transaction Accounting Adjustments before the column depicting Management's Adjustments.

(8)(i) Historical and pro forma basic and diluted per share amounts based on continuing operations attributable to the controlling interests and the number of shares used to calculate such per share amounts shall be presented on the face of the pro forma condensed statement of comprehensive income for both the pro forma total depicting the combined historical statements and Transaction Accounting Adjustments as well as the pro forma total depicting the combined historical statements, Transaction Accounting Adjustments, and Management's Adjustments, if any.

(ii) The number of shares used in the calculation of the pro forma per share amounts shall be based on the weighted average number of shares outstanding during the period adjusted to give effect to the number of shares issued or to be issued to consummate the transaction, or if applicable whose proceeds will be used to consummate the transaction as if the shares were outstanding as of the beginning of the period presented. Calculate the pro forma effect of potential common stock being issued in the transaction (e.g., a convertible security), or the proceeds of which will be used to consummate the transaction, on pro forma earnings per share in accordance with U.S. GAAP or IFRS-IASB, as applicable, as if the potential common stock were outstanding as of the beginning of the period presented. If a Management's Adjustment will change the number of shares or potential common shares, reflect the change within Management's Adjustment in accordance with U.S. GAAP or IFRS-IASB, as applicable, as if

the common stock or potential common stock were outstanding as of the beginning of the period presented.

(9) If the transaction is structured in such a manner that significantly different results may occur, provide additional pro forma presentations which give effect to the range of possible results.

(10) The accompanying explanatory notes shall disclose:

(i) Revenues, expenses, gains and losses and related tax effects which will not recur in the income of the registrant beyond 12 months after the transaction.

(ii) For Transaction Accounting Adjustments:

(A) A table showing the total consideration transferred or received including its components and how they were measured. If total consideration includes contingent consideration, describe the arrangement(s), the basis for determining the amount of payment(s) or receipt(s), and an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why; and

(B) The following information when the accounting is incomplete: a prominent statement to this effect; the items for which the accounting depicted is incomplete; a description of the information that the registrant requires, including, if material, the uncertainties affecting the pro forma financial information and the possible consequences of their resolution; an indication of when the accounting is expected to be finalized; and other available information that will enable a reader to understand the magnitude of any potential adjustments to the measurements depicted.

(iii) For each Management's Adjustment, a description, including the material uncertainties, of the synergy or other transaction effect, the material assumptions, the calculation of the adjustment, the estimated time frame for completion, and qualitative information

necessary to give a fair and balanced presentation of the pro forma financial information. To the extent known, the reportable segments, products, services, and processes involved; the material resources required, if any, and the anticipated timing.

(iv) For synergies and other transaction effects that are not reasonably estimable, qualitative information necessary for a fair and balanced presentation of the pro forma financial information.

(11) A registrant shall not:

(i) Present pro forma financial information on the face of the registrant's historical financial statements or in the accompanying notes, except where such presentation is required by U.S. GAAP or IFRS-IASB, as applicable.

(ii) Present summaries of pro forma financial information elsewhere in a filing that excludes material transactions for which pro forma effect is required to be given.

(iii) Give pro forma effect to the registrant's adoption of an accounting standard in pro forma financial information required by §§ 210.11-01 through 210.11-03 of this chapter.

(b) *Implementation guidance.* (1) *Historical statement of comprehensive income.* The historical statement of comprehensive income used in the pro forma financial information shall only be presented through income from continuing operations (or the appropriate modification thereof).

(2) *Business acquisitions.* In some transactions, such as in financial institution acquisitions, measuring the acquired assets at their acquisition date fair value may result in significant discounts relative to the acquired business's historical cost of the acquired assets. When such discounts can result in a significant effect on earnings (losses) in periods immediately subsequent to the acquisition that will be progressively eliminated over a relatively short period,

the effect of the discounts on reported results of operations for each of the next five years shall be disclosed in a note.

(3) *Business dispositions.* Transaction Accounting Adjustments giving effect to the disposition of a business shall not decrease historically incurred compensation expense for employees who were not, or will not be, transferred or terminated as of the disposition date. Adjustments to decrease historically incurred compensation expense for those employees shall be included in Management's Adjustments if they meet the requirements in § 210.11-02(a)(6)(ii).

(4) *Multiple transactions.* (i) When consummation of more than one transaction has occurred, or is probable, the pro forma financial information shall present in separate columns each transaction for which pro forma presentation is required by § 210.11-01.

(ii) If the pro forma financial information is presented in a proxy or information statement for purposes of obtaining shareholder approval of one of the transactions, the effects of that transaction must be clearly set forth.

(5) *Tax effects.* (i) 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 statements of comprehensive income are presented and should be reflected as a separate pro forma adjustment.

(ii) When the registrant's historical statements of comprehensive income do not reflect the tax provision on the separate return basis, pro forma statements of comprehensive income adjustments shall reflect a tax provision calculated on the separate return basis.

(c) *Periods to be presented.* (1) A pro forma condensed balance sheet as of the end of the most recent period for which a consolidated balance sheet of the registrant is required by § 210.3-01 shall be filed unless the transaction is already reflected in such balance sheet.

(2)(i) Pro forma condensed statements of comprehensive income shall be filed for only the most recent fiscal year, except as noted in paragraph (c)(2)(ii) of this section, and for the period from the most recent fiscal year end to the most recent interim date for which a balance sheet is required. A pro forma condensed statement of comprehensive income may be filed for the corresponding interim period of the preceding fiscal year. A pro forma condensed statement of comprehensive income shall not be filed when the historical statement of comprehensive income reflects the transaction for the entire period.

(ii) For transactions required to be accounted for under U.S. GAAP or, as applicable, IFRS-IASB by retrospectively revising the historical statements of comprehensive income (e.g., combination of entities under common control and discontinued operations), pro forma statements of comprehensive income shall be filed for all periods for which historical financial statements of the registrant are required. Retrospective revisions stemming from the registrant's adoption of a new accounting principle should not be reflected in pro forma statements of comprehensive income until they are depicted in the registrant's historical financial statements.

(3) Pro forma condensed statements of comprehensive income shall be presented using the registrant's fiscal year end. If the most recent fiscal year end of any other entity involved in the transaction differs from the registrant's most recent fiscal year end by more than one fiscal quarter, the other entity's statement of comprehensive income shall be brought up to within one fiscal quarter of the registrant's most recent fiscal year end, if practicable. This updating could be accomplished by adding subsequent interim period results to the most recent fiscal year end information and deducting the comparable preceding year interim period results. Disclosure shall be made of the periods combined and of the sales or revenues and income for any periods which were excluded from or included more than once in the condensed pro forma statement of

comprehensive income (e.g., an interim period that is included both as part of the fiscal year and the subsequent interim period).

INSTRUCTION TO PARAGRAPH (c)(3): In circumstances where different fiscal year ends exist, §210.3-12 may require a registrant to include in the pro forma financial information an acquired or to be acquired foreign business historical period that would be more current than the periods included in the required historical financial statements of the foreign business.

(4) Whenever unusual events enter into the determination of the results shown for the most recently completed fiscal year, the effect of such unusual events should be disclosed and consideration should be given to presenting a pro forma condensed statement of comprehensive income for the most recent twelve-month period in addition to those required in paragraph (c)(2)(i) of this section if the most recent twelve-month period is more representative of normal operations.

#### **§ 210.11-03 [Amended]**

19. Amend § 210.11-03 by:

a. In paragraph (a) introductory text, removing “§ 210.11-02(b)(1)” and adding in its place “§ 210.11-02(a)(1)”; and

b. In paragraph (a)(2), removing “§ 210.11-02(b)(3)” and adding in its place “§ 210.11-02(a)(3)”.

c. In paragraph (d), removing “generally accepted accounting principles” and adding in its place “U.S. GAAP or IFRS-IASB.”

#### **PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933**

20. The authority citation for part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. 112-106, sec. 201(a), sec. 401, 126 Stat. 313 (2012), unless otherwise noted.

\* \* \* \* \*

21. Amend §230.405 by revising the definition of “Significant subsidiary” to read as follows:

**§ 230.405 Definitions of terms.**

\* \* \* \* \*

*Significant subsidiary.* The term *significant subsidiary* means a subsidiary, including its subsidiaries, which meets any of the conditions in paragraphs (1), (2), or (3) of this definition; however, if the subsidiary is a registered investment company or a business development company, it meets any of the conditions in paragraph (4) of this definition instead of any of the conditions in paragraphs (1), (2), or (3) of this definition. A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles (U.S. GAAP) shall use amounts determined under U.S. GAAP. A foreign private issuer that files its financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) shall use amounts determined under IFRS-IASB.

(1) *Investment test.* (i) The registrant’s and its other subsidiaries’ investments in and advances to the tested subsidiary exceed 10 percent of the aggregate worldwide market value of the registrant’s voting and non-voting common equity, or if the registrant has no such aggregate worldwide market value, the total assets of the registrant and its subsidiaries consolidated as of

the end of the most recently completed fiscal year. Aggregate worldwide market value of the registrant's voting and non-voting common equity shall be determined as of the last business day of the registrant's most recently completed fiscal year, which for acquisitions and dispositions shall be at or prior to the date of acquisition or disposition;

(ii) For a combination between entities or businesses under common control, this test shall be met when either the net book value of the tested subsidiary exceeds 10 percent of the registrant's and its subsidiaries' consolidated total assets or the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated;

(iii) For all other acquisitions, the "investment in" the tested subsidiary shall include the fair value of contingent consideration if required to be recognized at fair value at the acquisition date; however if recognition at fair value is not required, include all contingent consideration, except sales-based milestones and royalties, unless the likelihood of payment is remote. The "investment in" the tested subsidiary also excludes the registrant's and its subsidiaries' proportionate interest in the carrying value of assets transferred by the registrant and its subsidiaries consolidated to the tested subsidiary that will remain with the combined entity after the acquisition; and

(iv) For dispositions, the "investment in" the tested subsidiary shall equal the fair value of the consideration, which shall include contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant or, when the registrant has no such aggregate worldwide market value, the carrying value of the disposed subsidiary when comparing to total assets of the registrant. For a real estate operation as defined in § 210.3-14(a)(2), when the investment test is based on the total assets of the registrant and its



subsidiaries consolidated, include any debt secured by the real properties that is assumed by the buyer in the “investment in” the tested real estate operation.

(2) *Asset test.* The registrant’s and its other subsidiaries’ proportionate share of the total assets (after intercompany eliminations) of the tested subsidiary exceeds 10 percent of such total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(3) *Income test.* (i)(A) The absolute value of the registrant’s and its other subsidiaries’ equity in the tested subsidiary’s consolidated income or loss from continuing operations (after intercompany eliminations) attributable to the controlling interests exceeds 10 percent of the absolute value of such income or loss of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; and

(B) The registrant’s and its other subsidiaries’ proportionate share of the tested subsidiary’s consolidated total revenue (after intercompany eliminations) exceeds 10 percent of such total revenue of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. This component does not apply if either the registrant and its subsidiaries consolidated or the tested subsidiary does not have recurring annual revenue.

(ii) When determining the income component in paragraph (3)(i)(A) of the definition of *significant subsidiary* in this section:

(A) If a net loss from continuing operations attributable to the controlling interest has been incurred by either the registrant and its subsidiaries consolidated or the tested subsidiary, but not both, exclude the equity in the income or loss from continuing operations of the tested subsidiary attributable to the controlling interest from such income or loss of the registrant and its subsidiaries consolidated for purposes of the computation; and

(B) Compute the test using the average described herein if the revenue component in paragraph (3)(i)(B) of the definition of *significant subsidiary* in this section does not apply and the absolute value of the registrant's and its consolidated subsidiaries' income or loss from continuing operations attributable to the controlling interests for the most recent fiscal year is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years.

(4) For a registrant that is a registered investment company or a business development company, the term *significant subsidiary* means a subsidiary, including its subsidiaries, which meets any of the following conditions using amounts determined under U.S. GAAP and, if applicable, section 2(a)(41) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(41)):

(i) *Investment test.* The value of the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

(ii) *Income test.* The absolute value of the combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary, for the most recently completed fiscal year exceeds:

(A) 80 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; or

(B) 10 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year and the investment test condition (paragraph (4)(i) of the definition of *significant subsidiary* in this

section) exceeds 5 percent. However, if the registrant and its subsidiaries consolidated has an insignificant change in net assets resulting from operations for its most recently completed fiscal year, 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.

\* \* \* \* \*

## **PART 239 – FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933**

22. The authority citation for part 239 continues to read, in part, as follows:

AUTHORITY: 15 U.S.C. 77c, 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78o-7 note, 78u-5, 78w(a), 78ll, 78mm, 80a-2(a), 80a-3, 80a-8, 80a-9, 80a-10, 80a-13, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37; and sec. 107, Pub. L. 112-106, 126 Stat. 312, unless otherwise noted.

\* \* \* \* \*

23. Form N-14 (referenced in § 239.23) is amended to revise Item 14 to read as follows:

**Note: The text of Form N-14 does not, and this amendment will not, appear in the Code of Federal Regulations.**

### **FORM N-14**

\* \* \* \* \*

#### **Item 14. Financial Statements**

The Statement of Additional Information shall contain the financial statements, including the schedules thereto, and supplemental financial information of the acquiring company and the company to be acquired required by Regulation S-X [17 CFR 210] for the periods specified in Article 3 and Rule 6-11 of Regulation S-X, except:

1. if the company to be acquired is an investment company or would be an investment company but for the exclusions provided by sections 3(c)(1) or 3(c)(7) of the 1940 Act [15 U.S.C. 80a-3(c)(1) and (c)(7)] (a “private fund”), the financial statements need only be filed for the most recent fiscal year and the most recent interim period;
2. if the company to be acquired is a private fund, then such company may provide the financial statements, including the schedules thereto, described in Rule 3-18 of Regulation S-X that comply with U.S. Generally Accepted Accounting Principles and only Article 12 of Regulation S-X;
3. the financial statements required by Regulation S-X for any subsidiary that is not a majority-owned subsidiary may be omitted from Part B and included in Part C; and
4. the table showing the current fees and pro forma fees, if different, required by Rule 6-11 of Regulation S-X (which is required by Item 3 of this Form).

**PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

24. The authority citation for part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et seq.; and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111-203, 939A, 124 Stat. 1887 (2010); and secs. 503 and 602, Pub. L. 112-106, 126 Stat. 326 (2012), unless otherwise noted.

\* \* \* \* \*

25. Amend §240.12b-2 by revising the definition of “Significant subsidiary” to read as follows:

## § 240.12b-2 Definitions.

\* \* \* \* \*

*Significant subsidiary.* The term *significant subsidiary* means a subsidiary, including its subsidiaries, which meets any of the conditions in the following paragraphs (1), (2), or (3) of this definition; however, if the subsidiary is a registered investment company or a business development company, it meets any of the conditions in paragraph (4) of this definition instead of any of the conditions in paragraphs (1), (2), or (3) of this definition. A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles (U.S. GAAP) shall use amounts determined under U.S. GAAP. A foreign private issuer that files its financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) shall use amounts determined under IFRS-IASB.

(1) *Investment test.* (i) The registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the aggregate worldwide market value of the registrant's voting and non-voting common equity, or if the registrant has no such aggregate worldwide market value, the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year. Aggregate worldwide market value of the registrant's voting and non-voting common equity shall be determined as of the last business day of the registrant's most recently completed fiscal year, which for acquisitions and dispositions shall be at or prior to the date of acquisition or disposition;

(ii) For a combination between entities or businesses under common control, this test shall be met when either the net book value of the tested subsidiary exceeds 10 percent of the registrant's and its subsidiaries' consolidated total assets or the number of common shares

exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated;

(iii) For all other acquisitions, the “investment in” the tested subsidiary shall include the fair value of contingent consideration if required to be recognized at fair value at the acquisition date; however if recognition at fair value is not required, include all contingent consideration, except sales-based milestones and royalties, unless the likelihood of payment is remote. The “investment in” the tested subsidiary also excludes the registrant’s and its subsidiaries’ proportionate interest in the carrying value of assets transferred by the registrant and its subsidiaries consolidated to the tested subsidiary that will remain with the combined entity after the acquisition; and

(iv) For dispositions, the “investment in” the tested subsidiary shall equal the fair value of the consideration, which shall include contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant or, when the registrant has no such aggregate worldwide market value, the carrying value of the disposed subsidiary when comparing to total assets of the registrant. For a real estate operation as defined in § 210.3-14(a)(2), when the investment test is based on the total assets of the registrant and its subsidiaries consolidated, include any debt secured by the real properties that is assumed by the buyer in the “investment in” the tested real estate operation.

(2) *Asset test.* The registrant’s and its other subsidiaries’ proportionate share of the total assets (after intercompany eliminations) of the tested subsidiary exceeds 10 percent of such total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(3) *Income test.* (i)(A) The absolute value of the registrant's and its other subsidiaries' equity in the tested subsidiary's consolidated income or loss from continuing operations (after intercompany eliminations) attributable to the controlling interests exceeds 10 percent of the absolute value of such income or loss of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; and

(B) The registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenue (after intercompany eliminations) exceeds 10 percent of such total revenue of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. This component does not apply if either the registrant and its subsidiaries consolidated or the tested subsidiary does not have recurring annual revenue.

(ii) When determining the income component in paragraph (3)(i)(A) of the definition of *significant subsidiary* in this section:

(A) If a net loss from continuing operations attributable to the controlling interest has been incurred by either the registrant and its subsidiaries consolidated or the tested subsidiary, but not both, exclude the equity in the income or loss from continuing operations of the tested subsidiary attributable to the controlling interest from such income or loss of the registrant and its subsidiaries consolidated for purposes of the computation; and

(B) Compute the test using the average described herein if the revenue component in paragraph (3)(i)(B) of the definition of *significant subsidiary* in this section does not apply and the absolute value of the registrant's and its consolidated subsidiaries' income or loss from continuing operations attributable to the controlling interests for the most recent fiscal year is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years.

(4) For a registrant that is a registered investment company or a business development company, the term *significant subsidiary* means a subsidiary, including its subsidiaries, which meets any of the following conditions using amounts determined under U.S. GAAP and, if applicable, section 2(a)(41) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(41)):

(i) *Investment test.* The value of the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

(ii) *Income test.* The absolute value of the combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary, for the most recently completed fiscal year exceeds:

(A) 80 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; or

(B) 10 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year and the Investment Test condition (paragraph (4)(i) of the definition of *significant subsidiary* in this section) exceeds 5 percent. However, if the registrant and its subsidiaries consolidated has an insignificant change in net assets resulting from operations for its most recently completed fiscal year, 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.

\* \* \* \* \*

**§240.14a-101 [Amended]**



26. Amend §240.14a-101, Item 14(d)(5) by removing the phrase “Rule 3-05 and Article 11 of Regulation S-X” and adding in its place “Rules 3-05, 6-11, and Article 11 of Regulation S-X”.

#### **PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934**

27. The authority citation for part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; 12 U.S.C. 5461 et seq.; 18 U.S.C. 1350; Sec. 953(b), Pub. L. 111-203, 124 Stat. 1904; Sec. 102(a)(3), Pub. L. 112-106, 126 Stat. 309 (2012); Sec. 107, Pub. L. 112-106, 126 Stat. 313 (2012), and Sec. 72001, Pub. L. 114-94, 129 Stat. 1312 (2015), unless otherwise noted.

\*\*\*\*\*

28. Form 8-K (referenced in §249.308) is amended by revising the introductory text to Item 2.01, Instruction 4 to Item 2.01, and Item 9.01.

The revisions to read as follows:

**Note: The text of Form 8-K does not, and this amendment will not, appear in the Code of Federal Regulations.**

#### **FORM 8-K**

\* \* \* \* \*

#### **Item 2.01 Completion of Acquisition or Disposition of Assets.**

If the registrant or any of its subsidiaries consolidated has completed the acquisition or disposition of a significant amount of assets, otherwise than in the ordinary course of business, or the acquisition or disposition of a significant amount of assets that constitute a real estate operation as defined in § 210.3-14(a)(2) disclose the following information:

\* \* \* \* \*

*Instructions.* \* \* \*

4. An acquisition or disposition shall be deemed to involve a significant amount of assets:

(i) If the registrant's and its other subsidiaries' equity in the net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries;

(ii) If it involved a business (see 17 CFR 210.11-01(d)) that is significant (see 17 CFR 210.11-01(b)); or

(iii) In the case of a business development company, if the amount paid for such assets exceeded 10% of the value of the total investments of the registrant and its consolidated subsidiaries.

The aggregate impact of acquired businesses are not required to be reported pursuant to this Item 2.01 unless they are related businesses (see 17 CFR 210.3-05(a)(3)), related real estate operations (see 17 CFR 210.3-14(a)(3)), or related funds (see 17 CFR 210.6-11(a)(3)), and are significant in the aggregate.

5. Attention is directed to the requirements in Item 9.01 (Financial Statements and Exhibits) with respect to the filing of:

(i) Financial statements of businesses or funds acquired;

\* \* \* \* \*

### **Item 9.01 Financial Statements and Exhibits.**

List below the financial statements, pro forma financial information and exhibits, if any, filed as a part of this report.

(a) Financial statements of businesses or funds acquired.

(1) For any business acquisition or fund acquisition required to be described in answer to Item 2.01 of this form, file financial statements and any applicable supplemental information, of the business acquired specified in Rules 3-05 or 3-14 of Regulation S-X (17 CFR 210.3-05(b) and 210.3-14), or Rules 8-04 or 8-06 of Regulation S-X (17 CFR 210.8-04(b) and 210.8-06) for smaller reporting companies, or of the fund acquired specified in Rule 6-11 of Regulation S-X (17 CFR 210.6-11).

(2) The financial statements shall be prepared pursuant to Regulation S-X except that supporting schedules need not be filed unless required by Rule 6-11 of Regulation S-X (17 CFR 210.6-11). A manually signed accountant's report should be provided pursuant to Rule 2-02 of Regulation S-X (17 CFR 210.2-02).

(3) Financial statements required by this item may be filed with the initial report, or by amendment not later than 71 calendar days after the date that the initial report on Form 8-K must be filed. If the financial statements are not included in the initial report, the registrant should so indicate in the Form 8-K report and state when the required financial statements will be filed. The registrant may, at its option, include unaudited financial statements in the initial report on Form 8-K.

(b) Pro forma financial information.

(1) For any transaction required to be described in answer to Item 2.01 of this form, furnish any pro forma financial information that would be required pursuant to Article 11 of Regulation S-X (17 CFR 210) or Rule 8-05 of Regulation S-X (17 CFR 210.8-05) for smaller reporting companies unless it involves the acquisition of a fund subject to Rule 6-11 of Regulation S-X (17 CFR 210.6-11).

(2) The provisions of paragraph (a)(3) of this Item 9.01 shall also apply to pro forma financial information relative to the acquired business.

(c) Shell company transactions. The provisions of paragraph (a)(3) and (b)(2) of this Item shall not apply to the financial statements or pro forma financial information required to be filed under this Item with regard to any transaction required to be described in answer to Item 2.01 of this Form by a registrant that was a shell company, other than a business combination related shell company, as those terms are defined in Rule 12b-2 under the Exchange Act (17 CFR 240.12b-2), immediately before that transaction. Accordingly, with regard to any transaction required to be described in answer to Item 2.01 of this Form by a registrant that was a shell company, other than a business combination related shell company, immediately before that transaction, the financial statements and pro forma financial information required by this Item must be filed in the initial report. Notwithstanding General Instruction B.3. to Form 8-K, if any financial statement or any financial information required to be filed in the initial report by this Item 9.01(c) is previously reported, as that term is defined in Rule 12b-2 under the Exchange Act (17 CFR 240.12b-2), the registrant may identify the filing in which that disclosure is included instead of including that disclosure in the initial report.

(d) Exhibits. \* \* \*

Instruction.

During the period after a registrant has reported an acquisition pursuant to Item 2.01 of this form, until the date on which the financial statements specified by this Item 9.01 must be filed, the registrant will be deemed current for purposes of its reporting obligations under Section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)). With respect to filings under the Securities Act, however, registration statements will not be declared effective and post-effective

amendments to registration statements will not be declared effective unless financial statements meeting the requirements of Rule 3-05, Rule 3-14, and Rule 6-11 of Regulation S-X (17 CFR 210.3-05, 210.3-14, and 210.6-11), as applicable, are provided. In addition, offerings should not be made pursuant to effective registration statements, or pursuant to Rule 506 of Regulation D (17 CFR 230.506) where any purchasers are not accredited investors under Rule 501(a) of that Regulation, until the audited financial statements required by Rule 3-05, Rule 3-14, and Rule 6-11 of Regulation S-X (17 CFR 210.3-05, 210.3-14, and 210.6-11), as applicable, are filed; provided, however, that the following offerings or sales of securities may proceed notwithstanding that financial statements of the acquired business have not been filed:

- (a) Offerings or sales of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights;
- (b) Dividend or interest reinvestment plans;
- (c) Employee benefit plans;
- (d) Transactions involving secondary offerings; or
- (e) Sales of securities pursuant to Rule 144 (17 CFR 230.144).

\* \* \* \* \*

29. Form 10-K (referenced in § 249.310) is amended to revise Item 8.(a) of PART II to read as follows:

**Note: The text of Form 10-K does not, and this amendment will not, appear in the Code of Federal Regulations.**

#### **FORM 10-K**

#### **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES**

**EXCHANGE ACT OF 1934**  
**GENERAL INSTRUCTIONS**

\* \* \* \* \*

PART II. \* \* \*

**Item 8. Financial Statements and Supplementary Data.**

(a) Furnish financial statements meeting the requirements of Regulation S-X (§210 of this chapter), except § 210.3-05, § 210.3-14, § 210.6-11, § 210.8-04, § 210.8-05, § 210.8-06 and Article 11 thereof, and the supplementary financial information required by Item 302 of Regulation S-K (§ 229.302 of this chapter). Financial statements of the registrant and its subsidiaries consolidated (as required by Rule 14a-3(b)) shall be filed under this item. Other financial statements and schedules required under Regulation S-X may be filed as “Financial Statement Schedules” pursuant to Item 15, Exhibits, Financial Statement Schedules, and Reports on Form 8-K, of this form.

\* \* \* \* \*

**PART 270 – RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940**

30. The general authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, 80a-39, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

\* \* \* \* \*

31. Revise paragraph (k) of § 270.8b-2 to read as follows:

\*\*\*\*\*

(k) *Significant subsidiary.* The term “significant subsidiary” means a subsidiary, including its subsidiaries, which meets any of the following conditions, using amounts

determined under U.S. Generally Accepted Accounting Principles and, if applicable, section 2(a)(41) of the Act:

(i) *Investment test.* The value of the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

(ii) *Income test.* The absolute value of the combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary, for the most recently completed fiscal year exceeds:

(A) 80 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; or

(B) 10 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year and the Investment Test (paragraph (k)(i)) condition exceeds 5 percent. However, if the registrant and its subsidiaries consolidated has an insignificant change in net assets resulting from operations for its most recently completed fiscal year, 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.

**PART 274 – FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940**

32. The general authority citation for part 274 continues to read, in part, as follows:

AUTHORITY: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, 80a-29, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

\* \* \* \* \*

33. Form N-2 (referenced in §§ 239.14 and 274.11a-1) is amended as follows:

a. Revise Item 8.6, paragraph (a) to Instruction 1 by removing the phrase “Sections 210.6-01 through 210.6-10 of Regulation S-X [17 CFR 210.6-01 through 210.6-10]” and adding in its place “Article 6 of Regulation S-X [17 CFR 210.6-01 et seq.]”.

b. Revise Item 24, paragraph (a) to Instruction 1 by removing the phrase “Sections 210.6-01 through 210.6-10 of Regulation S-X [17 CFR 210.6-01 through 210.6-10]” and adding in its place “Article 6 of Regulation S-X [17 CFR 210.6-01 et seq.]”.

**Note: The text of Form N-2 does not, and this amendment will not, appear in the Code of Federal Regulations.**

By the Commission.

Dated: May 3, 2019.

Eduardo A. Aleman,  
Deputy Secretary.