

**SECURITIES AND EXCHANGE COMMISSION**

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

**Release No. 33-10786; 34-88914; IC-33872; File No. S7-05-19**

**RIN 3235-AL77**

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

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** We are adopting amendments to our rules and forms to improve their application, assist registrants in making more meaningful determinations of whether a subsidiary or an acquired or disposed business is significant, and to improve the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses, including real estate operations and investment companies. The 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:** The final rules are effective on January 1, 2021.

*Compliance Dates:* See Section II.F. for further information on transitioning to the final rules.

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**SUPPLEMENTARY INFORMATION:**

We are adopting amendments to:

<b>Commission Reference</b>		<b>CFR Citation (17 CFR)</b>
Regulation S-X		§§ 210.1-01 through 210.13-02
	Rule 1-02(w)	§ 210.1-02(w)
	Rule 3-05	§ 210.3-05
	Rule 3-06	§ 210.3-06
	Rule 3-09	§ 210.3-09
	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
	Form S-11	§ 239.18
	Form N-2	§ 239.14 and § 274.11a-1
	Form N-14	§ 239.23
	Form 1-A	§ 239.90

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

Securities Exchange Act of 1934 (Exchange Act) <sup>2</sup>	Exchange Act Rule 12b-2	§ 240.12b-2
	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 adding 17 CFR § 210.6-11 (new “Rule 6-11”) to Regulation S-X.

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<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**

On May 3, 2019, the Commission proposed amendments to improve for investors the financial information about acquired and disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure.<sup>4</sup> Specifically, the Commission proposed amendments to the requirements for financial statements relating to acquisitions and dispositions of businesses, including real estate operations, in Regulation S-X Rule 3-05,<sup>5</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*; and other related rules and forms.<sup>6</sup> The proposed amendments resulted from an ongoing, comprehensive evaluation of our disclosure requirements.<sup>7</sup> The Commission also

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<sup>4</sup> See *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, Release No. 33-10635 (May 3, 2019) [84 FR 24600 (May 28, 2019)] (“Proposing Release”).

<sup>5</sup> Unless otherwise noted, references in this release to “Rule” or “Rules” are to the rules under Regulation S-X.

<sup>6</sup> The Commission also proposed related amendments to Regulation S-X with respect 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, the Commission proposed amendments to Form 8-K for current reports, Form 10-K for annual and transition reports, and the definition of “significant subsidiary” in Exchange Act Rule 12b-2, Securities Act Rule 405, and Rule 8b-2 under the Investment Company Act.

<sup>7</sup> The staff, under its Disclosure Effectiveness Initiative, is reviewing the disclosure requirements in Regulation S-X and in 17 CFR 229.10 through 1305 (“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

proposed new Rule 6-11 and amendments to Form N-14 to specifically govern financial reporting for acquisitions involving investment companies.

Under Rule 3-05, a registrant that acquires a business<sup>8</sup> other than a real estate operation<sup>9</sup> is generally required 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, Rule 3-05 addresses the reporting requirements for businesses acquired or to be acquired based on the “significant subsidiary” definition in Rule 1-02(w) using a sliding scale approach.<sup>10</sup> A registrant that has acquired, or proposes to acquire, a significant real estate operation<sup>11</sup> similarly must file separate audited annual and unaudited interim abbreviated income statements with respect to such operations (“Rule 3-14 Financial Statements”).<sup>12</sup> Additionally, registrants required to file Rule 3-05 Financial Statements or Rule 3-14 Financial Statements also are

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requirements and make recommendations on how to update them to facilitate timely, material disclosure by companies and shareholders’ access to that information.

<sup>8</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.

<sup>9</sup> Rule 3-05 also applies to registrants that are registered investment companies and business development companies.

<sup>10</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”).

<sup>11</sup> 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.

<sup>12</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 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. Additionally, Rule 3-14 generally only requires one year of Rule 3-14 Financial Statements.

required to file unaudited pro forma financial information as prescribed by Article 11.<sup>13</sup> 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>14</sup> A similar 75-day filing period applies to registration statements and proxy statements for acquired or to be acquired businesses requiring Rule 3-05 Financial Statements,<sup>15</sup> but not for acquired or to be acquired businesses requiring Rule 3-14 Financial Statements.

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<sup>13</sup> See Rules 11-01 and 11-02. 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 statements of comprehensive income 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.

<sup>14</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 after 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.

<sup>15</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 percent 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).

In addition, certain registration statements<sup>16</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 percent for any combination of acquisitions subject to Rule 3-05.<sup>17</sup>

Commenters broadly supported the objectives of the proposed rules or were generally in favor of the proposals.<sup>18</sup> While commenters were largely supportive of the proposals, we also received recommendations for modifying or further considering aspects of the proposed amendments that commenters believed could be clarified and improved.<sup>19</sup> After reviewing and considering the public comments and recommendations, we are adopting the amendments largely as proposed. As we discuss further below, in certain cases we are adopting the proposed rules with modifications that are intended to address comments received.

## II. Discussion of Final Amendments<sup>20</sup>

We are amending the requirements in Rule 1-02(w), Rule 3-05, Rule 3-14, Article 11, and related rules and forms. The amendments generally:

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<sup>16</sup> This additional requirement does not apply to all registration statements, such as registration statements filed on 17 CFR 239.16b (“Form S-8”).

<sup>17</sup> See Rule 3-05(b)(2)(i). Smaller reporting companies provide the same disclosure under Rule 8-04(c)(3).

<sup>18</sup> Comment letters related to the Proposing Release are available at <https://www.sec.gov/comments/s7-05-19/s70519.htm>.

<sup>19</sup> In addition, the SEC’s Small Business Capital Formation Advisory Committee (“SBCFAC”) adopted a recommendation generally supportive of the proposed rules subject to their specific recommendations. See U.S. Securities & Exchange Commission Small Business Capital Formation Advisory Committee, Recommendation on the Commission’s Proposal to Amend Financial Disclosure Requirements Relating to Acquisitions and Dispositions of Businesses (Aug. 23, 2019) (“SBCFAC Recommendations”), available at <https://www.sec.gov/spotlight/sbcfac/recommendations-rule-3-05-and-accelerated-filer-definition.pdf>.

<sup>20</sup> Generally, the final amendments will not affect the financial statements related to the acquisition of a business that is the subject of a proxy statement or registration statement on 17 CFR 239.25 (“Form S-4”) or 17 CFR 239.34 (“Form F-4”); however, in certain circumstances application of the amended significance tests may

- Update the significance tests used under these and other rules to generally improve their application and assist registrants in making more meaningful significance determinations;
- Expand the use of pro forma financial information in measuring significance;
- Conform, to the extent applicable, the significance threshold and tests for a disposed business to those used for an acquired business;
- Require the financial statements of the acquired business to cover only up to the two most recent fiscal years;
- Permit disclosure of abbreviated financial statements for certain acquisitions of a component of an entity;
- 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 audited annual financial statements for either nine months or a complete fiscal year, depending on significance;
- 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;

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affect whether the financial statements of a subject business that is not an Exchange Act reporting company are required to be included in such a proxy statement or registration statement. The final amendments will apply to pro forma financial 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 do not affect the requirements in 17 CFR 210.3-02 (“Rule 3-02”) or Rule 8-01 relating to predecessor companies.

- Clarify the application of Rule 3-14 regarding the determination of significance, the need for interim income statements, special provisions for blind pool offerings,<sup>21</sup> and the scope of the rule’s requirements;
- Amend the pro forma financial information requirements to improve the content and relevance of such information;
- Clarify when financial statements and pro forma financial information are required, and update the language used in our rules to take into account concepts that have developed since adoption of the rules over 30 years ago; and
- Make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X.

In addition, we are amending regulatory requirements specific to investment companies registered under the Investment Company Act and business development companies<sup>22</sup> (collectively, “investment companies”) as discussed in more detail in Section II.E. below.

**A. Amendments to the Definition of “Significant Subsidiary” and Generally Applicable Financial Statement Requirements for Acquired Businesses**

The “significant subsidiary” definition in Rule 1-02(w) includes investment, asset, and income tests that are applied when determining if a subsidiary is deemed significant for the purposes of certain Regulation S-X and Regulation S-K requirements as well as certain Securities and Exchange Act rules and forms.<sup>23</sup> Whether an acquisition is significant under Rule

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<sup>21</sup> See Section II.C.6 below for a description of a blind pool offering.

<sup>22</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>23</sup> In addition to its use in Rule 3-05 and Rule 3-14, the Rule 1-02(w) definition of “significant subsidiary” is used in the following rules:

- 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;

3-05 is determined by applying these tests,<sup>24</sup> which generally can be described as follows:

- “Investment Test” – the registrant’s and its other subsidiaries’ investments in and advances to the acquired business are compared to the total assets of the registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date;

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- 17 CFR 210.11-01(b), which specifies when a business combination or disposition of a business shall be considered significant;
  - 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 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, to determine the subsidiaries that must be included in the list of subsidiaries required as an exhibit;
  - Item 17(b)(7) of Form S-4, to determine the financial statements required for domestic target companies being acquired that do not meet the requirements to use 17 CFR 239.34 (“Form S-3”);
  - Item 17(b)(5) of Form F-4, 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 bankruptcy, receivership or similar proceedings and the nature and results of any other material reclassification, merger, or consolidation, of 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.

<sup>24</sup> Rule 3-05 provides for use of a 20 percent significance threshold, rather than the 10 percent threshold indicated in Rule 1-02(w). The Commission raised the threshold in Rule 3-05 from 10 percent to 20 percent 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 and to undertake 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 have diverged from those used for Rule 3-14 and for dispositions since that time.

- “Asset Test” – the registrant’s and its other subsidiaries’ 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 statements required to be filed at or prior to the acquisition date; and
- “Income Test” – the registrant’s and its other subsidiaries’ 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 reflected in the registrant’s most recent annual financial statements required to be filed at or prior to the acquisition date.

### **1. Significance Tests**

We are amending the significance tests provided in Rule 1-02(w) to improve their application and to assist registrants in making more meaningful determinations of whether a subsidiary or an acquired or disposed business is significant. Specifically, we are revising the Investment Test and the Income Test and making other conforming changes. The Commission did not propose to substantively revise the Asset Test; however, a number of non-substantive revisions to the significance tests generally were proposed and are being adopted.<sup>25</sup> The final amendments also provide that, for acquisitions, intercompany transactions with the acquired business must be eliminated from the registrant’s and its subsidiaries’ consolidated total assets when computing the Asset Test.

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<sup>25</sup> For example, the final amendments label the conditions as the “Investment Test,” the “Asset Test,” and the “Income Test” and clarify that the significance tests compare the “tested” subsidiary’s amounts to the registrant’s.

**a. Investment Test**

The Investment Test compares the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary to the total assets of the registrant and its subsidiaries consolidated reflected at the end of the most recently completed fiscal year, or in the case of an acquired business, in the registrant's most recent annual financial statements required to be filed at or prior to the acquisition date.

**i. Proposed Amendments**

The Commission proposed to revise the Investment Test to compare the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary to the aggregate worldwide market value of the registrant's voting and non-voting common equity ("aggregate worldwide market value"), when available, and to retain the existing test when the registrant does not have an aggregate worldwide market value.<sup>26</sup> As proposed, aggregate worldwide market value would be determined as of the last business day of the registrant's most recently completed fiscal year, which for acquisitions and dispositions would be at or prior to the date of acquisition or disposition. The Commission additionally proposed amendments relating to

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<sup>26</sup> The value under the proposed rule would have differed from the value currently used by registrants to determine accelerated filer status under Exchange Act Rule 12b-2 because it would include the value of common equity held by affiliates and it would be determined as of the last business day of the registrant's most recently completed fiscal year. By contrast, Exchange Act 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* Exchange Act Rule 12b-2.

contingent consideration<sup>27</sup> and combinations between entities or businesses under common control.<sup>28</sup>

The Commission proposed the use of aggregate worldwide market value in the Investment Test to address a measurement mismatch: the comparison of the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary,<sup>29</sup> which for an acquisition or disposition is typically the purchase or sales price and is generally consistent with fair value, to the registrant's total assets measured at book value. Using aggregate worldwide market value instead of total assets was intended to address this mismatch for acquisitions and dispositions by comparing measures that are generally consistent with fair value, thereby providing a more meaningful measure of significance.

## ii. Comments

Commenters generally supported the proposal to revise the Investment Test.<sup>30</sup> Many commenters expressly supported the proposed use of aggregate worldwide market value of the

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<sup>27</sup> The Commission 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. For similar reasons, the Commission proposed 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>28</sup> The Commission proposed that the Investment Test would be met for a combination between entities or businesses under common control when either net book value of the tested subsidiary exceeds 10 percent 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 percent of its total common shares outstanding.

<sup>29</sup> 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, when referring to the conditions in Rule 1-02(w) in connection with the determination in Rule 3-05 and Rule 3-14.

<sup>30</sup> *See, e.g.*, letters from Bass Berry & Sims PLC ("Bass Berry"), Cravath, Swaine & Moore LLP ("Cravath"), Deloitte & Touche LLP ("DT"), Eli Lilly and Company ("Eli Lilly"), Institute of Management Accountants ("IMA"), KPMG LLP ("KPMG"), PNC Financial Services Group, Inc. ("PNC"), Securities Industry and

registrant's voting and non-voting common equity, when available.<sup>31</sup> Some commenters who supported the use of aggregate worldwide market value recommended measuring it closer to the date of the acquisition or disposition because of the potential fluctuation and volatility of the stock price.<sup>32</sup> Other commenters recommended extending the use of a fair value measure to initial public offerings, such as by allowing issuers to estimate their aggregate worldwide market value at the anticipated offering date.<sup>33</sup>

A number of commenters, however, expressed concern relating to the use of aggregate worldwide market value.<sup>34</sup> One of these commenters suggested that aggregate worldwide market value would introduce market volatility into the test.<sup>35</sup> Other commenters suggested that aggregate worldwide market value would not reflect fair value when significant amounts of stock are held by affiliates, the registrant is highly leveraged or its capital structure is complicated.<sup>36</sup>

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Financial Markets Association (“SIFMA”), and The Williams Companies, Inc. (“Williams”). We received no comments specific to our proposals to provide further instructions on a registrant’s and its other subsidiaries’ “investments in” the tested subsidiary for acquisitions and dispositions or to clarify the applicability of the Investment Test to combinations between entities under common control.

- <sup>31</sup> *See, e.g.*, letters from Ball Corporation (“Ball”), CFA Institute (“CFA”), Cravath, Davis Polk and Wardwell LLP (“Davis Polk”), DT, Eli Lilly, Financial Executives International (“FEI”), KPMG, MTBC, Inc. (“MTBC”), RSM US LLP (“RSM”), SIFMA, Shearman and Sterling LLP (“Shearman”), and Williams. *See also* SBCFAC Recommendations.
- <sup>32</sup> *See, e.g.*, letters from BDO USA LLP (“BDO”), Center for Audit Quality (“CAQ”), CFA, Cravath, Crowe LLP (“Crowe”), Davis Polk, DT, Ernst & Young LLP (“EY”), Grant Thornton LLP (“GT”), IMA, Liberty Global plc (“Liberty”), MTBC, KPMG, RSM, Sullivan & Cromwell LLP (“S&C”), and Shearman. Commenters recommended a variety of alternatives including particular dates, ranges of dates or averages linked to the announcement, agreement or transaction dates, the most recently completed fiscal quarter, or confidential submission or filing dates of registration statements. *See, e.g.*, BDO, CAQ, Crowe, Davis Polk, GT, RSM, S&C, SIFMA, and Shearman.
- <sup>33</sup> *See, e.g.*, letters from BDO, Crowe, EY, and RSM. *See also* letters from Cravath and Davis Polk suggesting additional accommodations for initial public offerings.
- <sup>34</sup> *See* letters from The Allstate Corporation (“Allstate”), Affiliated Managers Group, Inc. (“AMG”), Bass Berry, Council of Institutional Investors (“CII”), Davis Polk, Denbury Resources Inc. (“Denbury”), DT, GT, IMA, and Liberty.
- <sup>35</sup> *See* letter from AMG.
- <sup>36</sup> *See* letters from Allstate, Bass Berry, DT, and GT. *But see* letter from CFA (recommending using a lower significance threshold or supplementing the revised test in such circumstances).

Two commenters supported the use of aggregate worldwide market value for acquisitions and dispositions, but expressed concern about its use for measuring significance of equity method investees because it introduces a historical cost versus fair value disparity (*e.g.*, comparing investments in and advances to the equity method investee to the registrant’s aggregate worldwide market value).<sup>37</sup>

Some commenters recommended using the “enterprise value” of the registrant as a more accurate reflection of the fair value of the entities,<sup>38</sup> despite acknowledging a lack of agreed-upon definition of the term<sup>39</sup> or that enterprise value may necessitate adjustment to the numerator of the Investment Test to reflect leverage.<sup>40</sup> These commenters recommended a variety of potential definitions for enterprise value or adjustments to equity market value that could be made to calculate enterprise value.<sup>41</sup> Some commenters offered other alternatives, such as using

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<sup>37</sup> See letters from DT and Williams. DT recommended that the Commission consider any potential impact of such changes on Rules 3-09 and 4-08(g) and other existing rules and staff guidance, while Williams recommended expressly retaining the existing requirement when evaluating equity method investments for significance under Rule 4-08(g).

<sup>38</sup> See letters from Bass Berry, Cravath, Davis Polk, Denbury, IMA, Liberty, and Shearman. Liberty went further and suggested that an Investment Test using enterprise value obviates the need for other significance tests.

<sup>39</sup> See letters from IMA and Shearman.

<sup>40</sup> See letter from Shearman. The commenter noted that if enterprise value is used, the numerator would also need to be revised to account for leverage by using the sum of the purchase price paid and the amount of debt, net of cash and cash equivalents, assumed.

<sup>41</sup> See letters from Bass Berry, Davis Polk, IMA, and Shearman. Bass Berry recommended defining “enterprise value” as “(a) the equity value of the registrant (that is, the aggregate worldwide market value of the registrant’s common equity as set forth above), plus (b) the value of the registrant’s indebtedness, minority interests and preferred stock ..., less (c) the cash and cash equivalents of the registrant as of the end of its most recent fiscal year.” Cravath recommended using the sum of the investments in and advances to the tested subsidiary, plus total debt to be assumed compared to the sum of the aggregate worldwide market value plus total debt without eliminating cash. Shearman noted that the basic definition takes the fair value of the equity and adds total debt and subtracts cash and cash equivalents and suggested if the Commission were to use “net debt,” it would also need to adjust the purchase price to the sum of the purchase price paid and the amount of net debt assumed. IMA recommended that the Commission include the registrant’s common and preferred stock, as well as its debt (including finance lease obligations) and that a registrant be permitted to use either the carrying amount of debt and/or preferred stock without a readily-determinable fair value or the carrying amount of debt, preferred stock and the residual equity. Davis Polk recommended “the addition of the principal amount of the acquirer’s outstanding debt to its equity market value.”

the lower of the existing Investment Test denominator (the registrant’s consolidated total assets) or aggregate worldwide market value.<sup>42</sup> One commenter expressed concern that the proposed Investment Test could encourage certain transactions that, in the long-term, may not be in the best interest of an acquirer’s shareholders.<sup>43</sup>

In response to the Commission’s proposal to require that the registrant’s and its other subsidiaries’ “investments in” the tested subsidiary include contingent consideration, some commenters supported including the fair value of contingent consideration when it is required to be measured at fair value under U.S. GAAP<sup>44</sup> but expressed opposition or concern about including contingent consideration when the acquired business will be accounted for as an asset acquisition under U.S. GAAP.<sup>45</sup> Other commenters recommended permitting registrants to determine significance using the fair value of the contingent consideration arrangement when fair value is not required by U.S. GAAP or IFRS-IASB, as applicable,<sup>46</sup> or extending the proposed sales-based milestones and royalties exception.<sup>47</sup> One commenter more broadly recommended not requiring the inclusion of contingent consideration that is not required to be recognized under applicable accounting standards.<sup>48</sup> However, another commenter expressed concern that the exclusion of sales-based milestones and royalties from the Investment Test for acquisitions for which U.S. GAAP does not require contingent consideration to be measured at fair value may

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<sup>42</sup> See letters from Allstate and New York City Bar Association, Committee on Securities Regulation (“NYCBA – Sec.”).

<sup>43</sup> See letter from CII. See also *infra* at note 454 and accompanying text.

<sup>44</sup> See, e.g., letters from Allstate, AMG, Pfizer, Inc. (“Pfizer”), and SIFMA.

<sup>45</sup> See, e.g., letters from Pfizer, and SIFMA.

<sup>46</sup> See letter from IMA.

<sup>47</sup> See letters from IMA and SIFMA. See also Section II.A.1.a. of the Proposing Release.

<sup>48</sup> See letter from Cravath.

result in under-identification of acquisitions that would materially affect the registrant’s financial statements.<sup>49</sup>

### iii. Final Amendments

We are adopting amendments to the Investment Test, with modifications from what was proposed in response to comments received.

#### *Aggregate worldwide market value*

We are adopting amendments to the Investment Test, substantially as proposed, to compare the registrant’s and its other subsidiaries’ investments in and advances to the tested subsidiary to the aggregate worldwide market value of the registrant’s voting and non-voting common equity, when available,<sup>50</sup> but expressly limiting this amendment to acquisitions and dispositions.<sup>51</sup> As proposed, we are retaining the existing test for acquisitions and dispositions in circumstances where the registrant does not have an aggregate worldwide market value. We are also retaining the existing test when used for the additional purposes for which the Rule 1-02(w) definition is applicable.<sup>52</sup>

In an acquisition or disposition, the registrant’s and its other subsidiaries’ “investments in”<sup>53</sup> the tested subsidiary are generally the consideration transferred or received (*i.e.*, the

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<sup>49</sup> See letter from GT. Separately, GT also recommended clarifying whether all contingent consideration should be included in the numerator if the likelihood of payment of all contingent consideration or any part thereof is more than remote.

<sup>50</sup> As with the proposed rule, the value under the final rule differs from the value currently used by registrants to determine accelerated filer status under Exchange Act Rule 12b-2. See *supra* note 26.

<sup>51</sup> See Section II.A.1.c.iii below for a discussion about retaining the existing Investment Test in other circumstances. The final rules reorganize and renumber proposed Rule 1-02(w)(1)(i) to effect these changes.

<sup>52</sup> See Rule 1-02(w)(1)(i)(C) and the discussion on Conforming Changes *supra* Section II.A.1.c.

<sup>53</sup> The Investment Test uses the phrase “investments in and advances to.” In this way, the numerator of the Investment Test includes two parts: “investments in” and “advances to.” Our references to “investments in” in this release are intended to focus the particular discussion on the first part of the numerator of the Investment

purchase or sales price) for the net assets acquired or sold. For acquisitions and dispositions, we believe that aggregate worldwide market value more closely aligns with the purchase or sale price used in the numerator of the Investment Test and provides a measure that is readily available and objectively determined by the market. Use of aggregate worldwide market value in these circumstances will address the mismatch whereby purchase or sale price is a measure of net assets generally consistent with fair value while the registrant's total assets to which it is currently compared reflects gross assets measured at book value.<sup>54</sup>

We are not adopting the suggestion of some commenters to use "enterprise value" for the Investment Test. The use of aggregate worldwide market value, unlike "enterprise value," will avoid the need to define a term that does not have an agreed-upon definition. Moreover, it avoids having to establish additional adjustments to the "investments in and advances to" the tested subsidiary in order to convert the Investment Test numerator from essentially an equity value to an enterprise value, which we believe would be necessary if an enterprise value denominator were used. We also are not adopting the suggestion to use the lower of the existing Investment Test denominator (*i.e.*, the registrant's consolidated total assets) or aggregate worldwide market value. While we note the observation that a company with substantial assets that is highly leveraged may have a relatively small market capitalization, the suggested "lower of" standard is not linked to leverage nor do we believe the existence of leverage necessarily precludes the need for disclosure about acquired and disposed businesses.

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Test. Any such reference should not be read to suggest the numerator of the Investment Test excludes the second part, "advances to."

<sup>54</sup> The book value of the registrant's total assets may not fully reflect the registrant's current fair value. For example, the Investment Test uses the carrying value of a registrant's total assets as of the most recent annual 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.

In response to commenters' suggestions and concerns regarding market volatility, we are modifying the proposal to require registrants to use the average of aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition. We are persuaded by commenters who suggested that market volatility and changes in market value unrelated to the acquisition could affect the determination of aggregate worldwide market value. We believe that using a more recent measurement period that is averaged to moderate daily variability more accurately reflects aggregate worldwide market value for purposes of computing significance based on the purchase or sale price while retaining a readily available and easily determinable measure of aggregate worldwide market value.

As proposed, the final rules will continue to require use of the total assets of the registrant and its subsidiaries consolidated when a registrant does not have an aggregate worldwide market value. We did not modify the final rule to permit, as suggested by some commenters, the estimation of aggregate worldwide market value when no such market value exists because we believe such an approach could introduce, rather than eliminate, complexity, and would be inconsistent with our intent of requiring that the determination, where possible, be based on readily available and easily and objectively determinable amounts that exist at the earlier of the announcement or agreement date.<sup>55</sup>

#### *Contingent consideration*

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<sup>55</sup> For example, a public float approach similar to that in Item 10(f)(1) of Regulation S-K relies on an estimated public offering price measured relative to the filing date, which could cause the estimate to already encompass the value of the tested business when the acquisition has already occurred or when the anticipated offering or filing date occurs after the earlier of the announcement or agreement date.

We are amending the Investment Test, substantially as proposed, to clarify that for acquisitions, the registrant's and its other subsidiaries' "investments in"<sup>56</sup> the tested subsidiary is the consideration transferred, adjusted to exclude 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. The amendments further indicate that the registrant's and its other subsidiaries' "investments 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, it shall include all contingent consideration, except contingent consideration for which the likelihood of payment is remote. We believe inclusion of contingent consideration provides a more accurate measure of an acquired business's relative significance. We were not persuaded by commenters that contingent consideration should be excluded from the Investment Test when the acquired business (as defined in Rule 11-01(d)) will be accounted for as an asset acquisition under U.S. GAAP. Contingent consideration can be a material component of the consideration provided to acquire a Rule 11-01(d) business and its exclusion from the significance tests could result in the under-identification of acquisitions for which financial statements are necessary to reasonably inform investors.

The proposed amendment would have permitted the exclusion of contingent consideration in the form of sales-based milestones and royalties from the Investment Test when recognition of contingent consideration at fair value is not required under U.S. GAAP or IFRS-IASB, as applicable. The proposal was intended to promote ease of calculation while

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<sup>56</sup> See *supra* note 53.

maintaining the objective of the test as a reliable indicator of relative significance; however, commenter feedback made evident that there are a wide variety of contingent consideration arrangements with variable terms that require estimation beyond sales-based milestones and royalties. Rather than expanding the exclusion to encompass these other arrangements, we are persuaded by the commenter who observed that the exclusion of such consideration from the significance tests when the likelihood of their payment was more than remote could result in under-identification of acquisitions that would materially affect the registrant's financial statements. Therefore, the final amendments do not provide for any such exception.<sup>57</sup>

We are not persuaded by the suggestion to permit registrants to determine significance of an acquisition using the fair value of the contingent consideration arrangement when fair value is not required by U.S. GAAP or IFRS-IASB, as applicable, as a means to mitigate the risk that an acquisition may be deemed significant for arrangements for which there is a wide range of possible outcomes in the eventual amount of contingent consideration that may be owed. We note that the standard we are adopting is one employed in practice today. To the extent that unique facts and circumstances may trigger significance when financial statements are not reasonably necessary to inform investors, we believe such a situation is best addressed through Rule 3-13.<sup>58</sup>

#### *Other Amendments*

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<sup>57</sup> In order to further clarify the requirements related to the amount of contingent consideration to include in the Investment Test when recognition at fair value is not required under U.S. GAAP or IFRS-IASB, as applicable, the final rules modify the proposed language, which provided for inclusion of "all contingent consideration unless the likelihood of payment is remote," to require inclusion of "all contingent consideration, except contingent consideration for which the likelihood of payment is remote."

<sup>58</sup> See 17 CFR 210.3-13 ("Rule 3-13") of Regulation S-X, which provides that 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.

The final amendments provide, as proposed, that the registrant's and its other subsidiaries' "investments in" the tested subsidiary exclude the registrant's and its other subsidiaries' 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. The final amendments also provide, as proposed, that in a disposition, the registrant's and its other subsidiaries' "investments in" the tested subsidiary equal the fair value of the consideration (which includes contingent consideration) for the disposed subsidiary when comparing it to the registrant's aggregate worldwide market value or, when the registrant has no such aggregate worldwide market value, the carrying value of the disposed subsidiary when comparing it to the registrant's total assets. The final amendments additionally provide, as proposed, that the Investment Test is met when either 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 for combinations between entities or businesses under common control.<sup>59</sup>

#### **b. Income Test**

The Income Test compares the registrant's equity in the tested subsidiary's income from continuing operations before income taxes exclusive of amounts attributable to any noncontrolling interests to such income of the registrant for the most recently completed fiscal year. In the case of an acquisition, the Income Test similarly compares the registrant's equity in the income from continuing operations of the acquired business before income taxes, exclusive

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<sup>59</sup> The addition of net book value to the test recognizes that such combinations may be effected by transferring net assets, rather than exchanging shares, and that the resulting accounting by the entity who receives net assets or equity interests (*i.e.*, the receiving entity) typically recognizes the combination using the parent's historical carrying value of the transferred entity or business. *See, e.g.*, FASB ASC 805-50-30-5.

of amounts attributable to any noncontrolling interests, as reflected in the business's most recent annual pre-acquisition financial statements, to the same measure of the registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date.

#### **i. Proposed Amendments**

The Commission proposed to revise the Income Test to reduce the anomalous results that may occur by relying solely on net income<sup>60</sup> and to reduce complexity and preparation costs without sacrificing material information for investors. The Commission proposed to:

- Add a new revenue component to the test;
- Revise the net income component to use income or loss from continuing operations *after* income taxes, instead of *before* income taxes;
- Calculate the net income component using absolute values;
- Revise the Income Test to use the average of the absolute value of net income when the existing 10 percent threshold in Computational Note 2 to Rule 1-02(w) is met and the proposed revenue component does not apply; and
- Make additional clarifications and simplifications.<sup>61</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 eliminations) to such consolidated total revenues of the registrant for the most recently completed fiscal year. Under the proposal, where the registrant and its subsidiaries

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<sup>60</sup> Net income can include infrequent expenses, gains, or losses that can distort the determination of relative significance.

<sup>61</sup> Specifically, the Commission proposed to 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) under certain conditions and to make additional non-substantive amendments to the net income component in order to simplify the description and application.

consolidated and the tested subsidiary have recurring annual revenue,<sup>62</sup> the tested subsidiary must meet both the new revenue component and the net income component, and in the case of the application of the test in Rule 3-05, could use the lower percentage of the revenue component and the net income component to determine the number of periods for which Rule 3-05 Financial Statements are required.

## ii. Comments

Commenters broadly supported the revisions to the Income Test and made various recommendations to improve specific components of the Income Test.<sup>63</sup>

### *Revenue Component*

Commenters broadly supported the addition of a revenue component to the Income Test.<sup>64</sup> One commenter recommended establishing significance when registrants meet either revenue or net income.<sup>65</sup> Another commenter noted that the inclusion of the revenue component would reduce instances of anomalous significance results, but noted that using a lower of revenue or net income approach could result in under-identification of acquisitions expected to have a material future impact and suggested considering the use of a lower revenue threshold.<sup>66</sup>

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<sup>62</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.

<sup>63</sup> *See, e.g.*, letters from Bass Berry, Cravath, DT, Eli Lilly, IMA, KPMG, PNC, SIFMA, and Williams. We received no comments on the additional clarifications and simplifications.

<sup>64</sup> *See, e.g.*, letters from AMG, Ball, Bass Berry, BDO, Cravath, Eli Lilly, FEI, GT, Liberty, NYCBA – Sec., Pfizer, PricewaterhouseCoopers LLP (“PWC”), SIFMA, Shearman, and Williams. *See also* SBCFAC Recommendations. Some of these commenters suggested further accommodations for equity method investees. *See, e.g.*, letters from GT and AMG.

<sup>65</sup> *See* letter from CFA.

<sup>66</sup> *See* letter from GT. In contrast, one commenter explicitly supported using the same percentage thresholds for the revenue component and the income component and indicated its belief that there was no meaningful risk that the income component of the Income Test would under-identify material transactions. *See* letter from Cravath.

Another commenter suggested requiring only the revenue component, and not the income component, for smaller reporting companies.<sup>67</sup>

#### *Recurring annual revenues*

A number of commenters, particularly accounting and auditing firms, expressed concern that the term “recurring annual revenues” may not be clear and requested additional guidance as to the meaning.<sup>68</sup> One commenter recommended using “two or more years of revenue” as an alternative.<sup>69</sup>

#### *Income taxes*

A few commenters supported the proposal to use income from continuing operations *after* income taxes because it would simplify the calculation and would permit registrants to use information directly from the income statement.<sup>70</sup> However, many other commenters recommended that the Commission continue to use income or loss from continuing operations *before* income taxes in the Income Test.<sup>71</sup> While using after-tax amounts may simplify the determinations, these commenters expressed concern that after-tax numbers could distort the significance determination due to factors such as the tax status of the entity (such as for a pass-through entity)<sup>72</sup> or the volatility of income taxes (due to changes in tax laws or valuation allowances).<sup>73</sup>

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<sup>67</sup> See letter from MTBC.

<sup>68</sup> See, e.g., letters from BDO, CAQ, Cravath, Crowe, DT, EY, GT, KPMG, MTBC, PWC, RSM, and SIFMA.

<sup>69</sup> See letter from MTBC.

<sup>70</sup> See letters from Ball and Eli Lilly.

<sup>71</sup> See, e.g., letters from AMG, BDO, CAQ, Cravath, Crowe, EY, FEI, GT, KPMG, Pfizer, PWC, Ira Rosner (“Rosner”), RSM, Shearman, and Williams.

<sup>72</sup> See, e.g., letters from AMG, BDO, CAQ, Cravath, Crowe, EY, GT, KPMG, PWC, Rosner, RSM, and Williams.

<sup>73</sup> See, e.g., letters from CAQ, EY, FEI, KPMG, Pfizer, PWC, and RSM.

### *Income averaging and use of absolute values*

Commenters generally supported the revisions relating to income averaging calculations<sup>74</sup> and the use of absolute values.<sup>75</sup> Some commenters recommended further revisions, such as using three-year averaging or permitting five-year averaging for all registrants regardless of recurring revenue.<sup>76</sup>

### **iii. Final Amendments**

As discussed in more detail below, we are adopting the amendments to the Income Test substantially as proposed, but with some modifications to improve its application and to assist registrants in making more meaningful significance determinations.

#### *Revenue component*

As proposed, we are revising the Income Test to add a revenue component in order to reduce the anomalous result that registrants with marginal or break-even net income or loss in a recent fiscal year may be more likely to have tested subsidiaries deemed significant where they otherwise would not. This anomalous result is particularly relevant where it would require Rule 3-05 Financial Statements for acquisitions that otherwise would not be considered material to investors. To satisfy the Income Test under the final amendments, the tested subsidiary must meet both the revenue component and the net income component when the revenue component applies, and for purposes of the application of Rule 3-05, may 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. The new revenue component compares a registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenues

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<sup>74</sup> See letters from AMG, BDO, and Pfizer.

<sup>75</sup> See letters from AMG, Eli Lilly, IMA, and Pfizer.

<sup>76</sup> See, e.g., letters from AMG, BDO, and IMA.

(after intercompany eliminations) to such consolidated total revenues of the registrant for the most recently completed fiscal year. We are modifying the description of the tested subsidiary's consolidated total revenue to clarify that consolidated total revenue refers to consolidated total revenue from continuing operations (after intercompany eliminations).<sup>77</sup>

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 that will no longer be incurred (*e.g.*, interest expense) as well as infrequent expenses, such as those for litigation or impairment, can affect net income, but not revenue. The effect of historical expenses that will no longer be incurred and infrequent expenses on an income-based test may be to either deem as insignificant an acquired business that is expected to have a 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. While we considered other metrics, we believe the addition of “revenue” is a more appropriate indicator to help avoid anomalous results, and therefore, we added a revenue component to the net income component of the Income Test rather than have separate tests based on revenue and net income.<sup>78</sup> By revising the Income Test to require that the registrant exceed both the revenue and net income components when the revenue component applies, we believe the test will more accurately determine whether a tested subsidiary is significant to the registrant. This will also reduce the frequency of immaterial acquisitions being deemed significant for purposes of Rule 3-05.

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<sup>77</sup> See Rule 1-02(w)(1)(iii).

<sup>78</sup> Prior to 1974, the “significant subsidiary” definition included a revenue test, but not a net income test. In 1974, the Commission added a separate net income test. In 1981, the Commission eliminated the revenue test and retained 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*, Rel. No. 33-6359 (Nov. 6, 1981)[46 FR 56171 (Nov. 16, 1981)].

We are not adopting the recommendation to use a lower significance threshold for the revenue component to mitigate the potential risk that use of a lower of revenue or net income approach could result in under-identification of significant subsidiaries, and in particular of acquisitions expected to have a material future impact on the registrant. The risk of under-identification is not unique to a “lower of” approach, but rather is inherent in basing the requirement to provide financial information on percentage threshold tests. We believe under-identification risk is mitigated, however, because even if the Income Test is not satisfied, the definition of “significant subsidiary” could be met by satisfying either the Asset Test or the Investment Test. Further, to simplify compliance, the significant subsidiary percentage threshold historically has been the same for all tests included in the “significant subsidiary” definition, notwithstanding that the threshold has been changed from time to time. In light of these considerations, we do not find a compelling reason at this time to differentiate the threshold for the revenue component of the Income Test from the threshold used in the net income component of the Income Test and in the Asset and Investment Tests.

We also are not adopting the recommendation to apply only the revenue component, and not the income component, for smaller reporting companies. We continue to believe both components taken together are important indicators in determining the need for financial information about acquired and disposed businesses.

*Recurring annual revenue*

Under the proposed amendments, where either a registrant and its subsidiaries consolidated or the tested subsidiary did not have recurring annual revenue, the new revenue component would not have been available to determine the number of periods for which Rule 3-05 Financial Statements are required. However, we are persuaded by commenters who noted

that the term “recurring annual revenue,” as proposed, was not sufficiently clear to determine when the revenue component would apply and may have inappropriately suggested that there would be discretion in determining the amount of revenue to be included. The revenue component is unlikely to produce a meaningful assessment where the registrant or the tested subsidiary does not have material revenue over the course of time. We are therefore modifying the Income Test consistent with a comment we received, to provide that the revenue component does not apply if either the registrant and its subsidiaries consolidated or the tested subsidiary did not have material revenue in each of the two most recently completed fiscal years. We believe the amendment will allow registrants to determine more easily whether the revenue component applies, and when it does apply, will clarify that all revenues must be included.

#### *Income taxes*

The Commission proposed to calculate income or loss from continuing operations *after* income taxes, permitting a registrant to use line item disclosure from its financial statements, to simplify the determination. We are persuaded by commenters that using *after* tax information may result in significance determinations that are less consistent and meaningful because they could be distorted due to factors such as the tax status of the entity or the volatility of income taxes. We are therefore not adopting the proposed amendment to calculate income or loss from continuing operations *after* income taxes and are retaining the requirement to use income or loss from continuing operations *before* income taxes.

#### *Income averaging and use of absolute values*

We are adopting amendments, as proposed, to clarify the net income component by inserting references 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. We are also adopting as proposed the use of absolute values for calculating average net income. As noted above, commenters generally supported the improvements to income averaging calculations<sup>79</sup> and the use of absolute values.<sup>80</sup>

*Additional clarifications and simplifications*

We are additionally amending Rules 3-05(b)(3) and 11-01(b)(3) as proposed to clarify that the Income Test may be determined using the acquired business's revenues less the expenses permitted to be omitted by new Rules 3-05(e) and 3-05(f) if the business meets the conditions in those rules, as well as making additional non-substantive amendments to the net income component in order to simplify the description of the test. Specifically, we are replacing, as proposed, 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 revising Rule 1-02(w) to remove the Computational Note designation but retaining the substance of the notes in the rule and making conforming amendments consistent with the amendments to the revised Income Test. Additionally, we are revising Rule 1-02(w)(1)(iii)(B)(3) to 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 must be treated as if they are a single acquisition. Finally, we are moving the Note to Rule 1-02(w) into the rule itself.

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<sup>79</sup> See letters from AMG, BDO, and Pfizer. We are not adopting one commenter's recommendation to use a three-year average. The five-year average is a longstanding standard and it is not clear that a three-year average would yield a more meaningful outcome. We also are not adopting the recommendation to extend the use of income averaging when the revenue component applies. Under existing requirements, income averaging is required when its conditions for use are met. However, those conditions also limit its use to mitigating anomalous results. We believe the adoption of a revenue component will mitigate anomalous results more effectively while simplifying the Income Test, and that use of income averaging to mitigate anomalous results should therefore be necessary only when the revenue component does not apply.

<sup>80</sup> See letters from AMG, Eli Lilly, IMA, and Pfizer.

## **c. Conforming Changes**

### **i. Proposed Amendments**

As noted above, several of our 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>81</sup> The Commission’s proposed amendments to Rule 1-02(w) would update the definition and the tests therein, but would nonetheless result in these tests continuing to apply consistently across these applications. 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 Securities Act Rule 405 and Exchange Act Rule 12b-2 definitions historically have been generally consistent with the Rule 1-02(w) definition. Accordingly, the Commission proposed to conform the definitions of “significant subsidiary” in Securities Act Rule 405 and Exchange Act Rule 12b-2 to the amended definition in Rule 1-02(w).<sup>82</sup>

### **ii. Comments**

With the exception of equity method investments, commenters did not address the specific proposed conforming changes. Some commenters suggested that the use of aggregate worldwide market value in the proposed Investment Test could introduce a new historical cost versus fair value disparity when evaluating equity method investments under Rules 3-09 and 17 CFR 210.4-08(g) (“4-08(g)”) because the registrant’s and its other subsidiaries’ “investments in

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<sup>81</sup> See *supra* note 23.

<sup>82</sup> In the Proposing Release, the Commission proposed to exclude from the definition of “significant subsidiary” in Securities Act Rule 405 and Exchange Act Rule 12b-2 the proposed amendments to Rule 1-02(w) that would be applicable only to disclosure requirements under Regulation S-X, specifically proposed Rule 1-02(w)(1)(iii)(B)(3). Unlike these other rules, the definition of “significant subsidiary” in Rule 8b-2 historically has differed from the Rule 1-02(w) definition. As proposed, we also are conforming the Rule 8b-2 definition of “significant subsidiary” to the new definition added to Rule 1-02(w)(2) that is specifically tailored for investment companies. See Section II.E below.

and advances to” the investee may not be equivalent to a fair value amount when the investee is not newly acquired.<sup>83</sup> In expressing support for the addition of a revenue component to the Income Test when testing the significance of equity method investees under Rules 3-09 and 4-08(g), one of these commenters suggested several changes to the manner in which the revenue component would be calculated for equity method investees under Rules 3-09 and 4-08(g).<sup>84</sup> Another commenter noted that for equity method investees, whose revenues are not consolidated in the registrant’s financial statements, the results of the proposed revenue component of the Income Test may not be meaningful.<sup>85</sup>

### **iii. Final Amendments**

We are adopting the conforming amendments substantially as proposed with certain modifications in response to comments. The amendments are intended to reflect more accurately the relative significance to a registrant of a tested subsidiary and to reduce anomalous results in the application of the definition of “significant subsidiary.” As discussed in the Proposing Release, by maintaining the historical conformity between the “significant subsidiary” definitions, these amendments will avoid unnecessary regulatory complexity through consistent application of significance determinations made at the acquisition date and those made post-

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<sup>83</sup> See, e.g., letters from AMG, DT, and Williams.

<sup>84</sup> See letter from AMG. Specifically, the commenter recommended modifying the denominator of the revenue component to include all of the equity method investee’s GAAP revenue such that the revenue component would compare the registrant’s “proportionate share” of the equity method investee’s revenue to the sum of the registrant’s GAAP revenue and 100 percent of the equity method investee’s GAAP revenue, without which the commenter suggested the proposal would produce incongruous comparisons. The commenter further recommended guidance on how to calculate “proportionate share” to address situations where a registrant may receive a share of revenue from an equity method investee that is different from the percentage of equity that the registrant may own and requested that the guidance include some level of discretion to allow registrants to use a method reasonably calculated to reflect the economic benefit the registrant receives relative to the equity method investee’s GAAP revenue.

<sup>85</sup> See letter from GT.

acquisition when the acquired business is a subsidiary of the registrant.<sup>86</sup> In a change from the proposal and in order to simplify and maintain uniformity of the definition throughout our rules, the amendments to Securities Act Rule 405 and Exchange Act Rule 12b-2 will fully conform with the definition in Rule 1-02(w), including Rule 1-02(w)(1)(iii)(B)(3).

We are persuaded by commenters that using the registrant's aggregate worldwide market value instead of the registrant's total assets in the Investment Test would have inadvertently introduced a mismatch when evaluating equity method investments under Rules 3-09 and 4-08(g) because the registrant's and its other subsidiaries' "investments in and advances to" the investee may not be equivalent to a fair value amount when the investee is not newly acquired. Because a registrant's and its other subsidiaries' "investments in and advances to" would not necessarily be equivalent to fair value for purposes other than acquisitions or dispositions, we are also persuaded that the registrant's aggregate worldwide market value should not be used in place of the registrant's total assets for the additional purposes for which the "significant subsidiary" definition is used.<sup>87</sup> Accordingly, we are retaining the comparison to the registrant's total assets used in the existing Investment Test for testing significance of equity method investees under Rules 3-09 and 4-08(g), as well as for the additional purposes for which the definition is used.<sup>88</sup>

We are not adopting any modifications to the proposed Income Test in response to comments received related to its application under Rules 3-09 and 4-08(g) to investments accounted for using the equity method. We added the revenue component for acquisitions and

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<sup>86</sup> See Proposing Release at Section II.A.1.

<sup>87</sup> See *supra* note 23.

<sup>88</sup> *Id.*

dispositions of businesses to mitigate anomalous results produced by the current test based only on net income. We believe the revenue component can serve a similar role related to the application of Rules 3-09 and 4-08(g) to equity method investments.<sup>89</sup> Additionally, using a test based on an amount that is not consolidated is not unprecedented for investments accounted for using the equity method. As the Commission has noted, the Asset Test applies to Rule 4-08(g), even though the total assets of the equity method investee are not consolidated by the registrant.<sup>90</sup> Further, we believe the fact that significance is not determined on the basis of a single test and that Rule 4-08(g) disclosure about equity method investees is required if significance is met either individually or on an aggregated basis by any combination of investees at the 10 percent level will help mitigate any potential adverse effects and help to provide an appropriate level of financial information about equity method investees.<sup>91</sup>

## 2. Audited Financial Statements for Significant Acquisitions

Depending on the relative significance of the acquired or to be acquired business, Rule 3-05 Financial Statements may be required for up to three years.<sup>92</sup>

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<sup>89</sup> The staff considers this additional factor when exercising its delegated authority under Rule 3-13 when a registrant makes a request to omit Rule 3-09 financial statements on the basis that the current income test produces an anomalous result.

<sup>90</sup> *See 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)] at note 51 (“In 1994, Rule 3-09 was revised to eliminate the asset test; however, the test was retained for Rule 4-08(g) to ensure a minimum level of financial information about an investee when the investment test was small, but a registrant’s proportionate interest in the Investee’s assets was material, as might be the case for a highly-leveraged Investee. *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].”).

<sup>91</sup> We are not persuaded to provide additional guidance on determining “proportionate interest” for the revenue component. We observe that “proportionate interest” is required to determine basis difference under U.S. GAAP or IFRS-IASB, as applicable, as well as the equity in the income of the investee. We believe proportionate interest used for those purposes will inform its use for the revenue component. Similarly, we are not persuaded that the equity method investee’s revenue should be added to the registrant’s revenue as it is not part of that revenue.

<sup>92</sup> Rule 3-05 Financial Statements are required for the most recent fiscal year and any required interim periods if any of the Rule 3-05 significance tests exceeds 20 percent, but none exceeds 40 percent, a second year is

**a. Proposed Amendments**

The Commission proposed to revise Rule 3-05 to require only up to two years of Rule 3-05 Financial Statements. The Commission also proposed to revise Rule 3-05 for acquisitions where a significance test exceeds 20 percent, but none exceeds 40 percent, to require financial statements for the “most recent” interim period specified in Rules 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.

**b. Comments**

Commenters broadly supported the proposals,<sup>93</sup> with no commenters opposing the changes.

**c. Final Amendments**

We are adopting the amendments as proposed to revise Rule 3-05 to require up to two years of Rule 3-05 Financial Statements. Unlike the historical financial statements of the registrant upon which investors rely to make investment decisions about the registrant, Rule 3-05 Financial Statements are used, along with pro forma financial information, to discern how the acquired business may affect the registrant. Due to their age, the third year of Rule 3-05 Financial Statements is less likely to be indicative of the current financial condition, changes in financial condition, and results of operations of the acquired business. Such financial statements

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required if any test exceeds 40 percent, but none exceeds 50 percent, and a third year is generally required if any of the tests exceeds 50 percent. 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 exceeds 20 percent. *See* 17 CFR 210.3-05(b)(2). 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>93</sup> *See, e.g.*, letters from Ball, Bass Berry, CFA, Cravath, Eli Lilly, FEI, Liberty, National Association of Real Estate Investment Trusts (“NAREIT”), Nasdaq, Inc. (“Nasdaq”), NYCBA – Sec., S&C, and SIFMA. *See also* SBCFAC Recommendations.

also 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, 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 the disclosure. Such burdens are further exacerbated if a change in the acquired business's management or independent auditor has occurred, which may also delay a registrant's time to market and access to capital.

We are additionally amending Rule 3-05 as proposed for acquisitions where a significance test exceeds 20 percent, but none exceeds 40 percent, to require financial statements for the "most recent" interim period specified in Rules 3-01 and 3-02 rather than "any" interim period. The revision eliminates the need to provide a comparative interim period when only one year of audited Rule 3-05 Financial Statements is required. In these circumstances, we believe that the most recent interim period provides the most relevant and material information to investors. Requiring a comparative interim period when there is no requirement for a corresponding comparative annual period would have limited utility for investors and imposes an additional burden on registrants to prepare such information.

In adopting these changes, we note that 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."

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

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 or a line of business contained in more than one subsidiary of the selling entity. 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 may be impracticable and Commission staff has permitted registrants to instead provide audited abbreviated financial statements of the acquired business in the form of statements of assets acquired and liabilities assumed and statements of revenues and expenses.<sup>94</sup>

**a. Proposed Amendments**

The Commission proposed Rule 3-05(e) to permit registrants to provide audited abbreviated financial statements in the form of statements of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) if the acquired business met certain qualifying and presentation conditions.<sup>95</sup> More specifically, under proposed Rule 3-05(e), a registrant would be permitted to present audited abbreviated financial statements of an acquired or to be acquired business<sup>96</sup> if:

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<sup>94</sup> Commission staff has exercised delegated authority pursuant to Rule 3-13 in these circumstances. In addition, Commission staff has provided informal guidance to address practical questions related to these and other financial reporting issues in the Division of Corporation Finance's Financial Reporting Manual ("FRM"), available at <https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf> (last updated Dec. 1, 2017). The FRM is not a rule, regulation or statement of the Commission and the Commission has neither approved nor disapproved its content. See FRM at Section 2065 *Acquisition of Selected Parts of an Entity may Result in Less than Full Financial Statements* ("FRM 2065").

<sup>95</sup> The proposal did not specifically label the conditions as "qualifying conditions" and "presentation conditions." However, we are using these labels, in part, to clarify the requirements and, in part, to simplify the comparison between the final amendments and the proposed amendments.

<sup>96</sup> Neither the proposal nor the rules we are adopting affect the requirements in Rule 3-02 or 17 CFR 210.8-01 relating to predecessors.

- 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; and
- The seller has not maintained the distinct and separate accounts necessary to present financial statements that include the omitted expenses and it is impracticable to prepare such financial statements.

Under proposed Rule 3-05(e), if the acquired or to be acquired business satisfies the above conditions, the audited abbreviated financial statements must also conform to certain presentation conditions, including:

- 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.<sup>97</sup>

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<sup>97</sup> Specifically, the additional disclosure would include: 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.

## b. Comments

Commenters generally supported permitting abbreviated financial statements,<sup>98</sup> although one commenter recommended that the Commission consider whether abbreviated financial statements satisfy investors' needs when the acquired business is a significant portion of the selling entity.<sup>99</sup> This commenter recommended the Commission provide a threshold on what constitutes "substantially all"<sup>100</sup> and questioned whether using a "small portion of the selling entity" might be a better standard than "less than substantially all of the assets and liabilities of the seller."<sup>101</sup> Another commenter recommended requiring registrants to indicate how abbreviated financial statement information is integrated into the pro forma financial information and suggested that the Commission clarify what type of auditor assurance would be provided for abbreviated financial statement information.<sup>102</sup>

Some commenters sought additional clarification of the terms, such as defining "separate entity," "subsidiary," "segment," and "division" in the context of an acquisition.<sup>103</sup> Other commenters questioned the use of "impracticable" recommending further clarification or a reduced standard.<sup>104</sup> One commenter sought clarification on the meaning of "previously

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<sup>98</sup> See, e.g., letters from BDO, CAQ, Cravath, Debevoise & Plimpton LLP ("Debevoise"), DT, Eli Lilly, EY, FEI, GT, IMA, PWC, RSM, and S&C.

<sup>99</sup> See letter from GT.

<sup>100</sup> *Id.* GT noted that absent any threshold, there would likely be diversity in how registrants interpret this phrase.

<sup>101</sup> See letter from GT. This commenter noted that in the Proposing Release the Commission had recognized that there could be challenges in making allocations of the selling entity's corporate overhead, interest, and taxes when the acquired business constitutes only a small portion of the selling entity. However, the commenter stated its view that the language in the proposed rule would allow registrants that acquire a significant portion of the selling entity to present abbreviated financial statements, as long as such business does not meet any of the other conditions outlined in the proposal.

<sup>102</sup> See letter from CFA.

<sup>103</sup> See, e.g., letters from CAQ, Crowe, DT, PWC, and RSM.

<sup>104</sup> See, e.g., letters from Debevoise, EY and GT.

prepared.”<sup>105</sup> Another commenter requested that the Commission clarify the nature of expenses to be included in the abbreviated financial statements by describing those that may be omitted or those that must be presented, but not both, noting that it is unclear whether the identified expenses are intended to be all-inclusive.<sup>106</sup>

Some commenters sought clarification of when carve-out financial statements of an acquired business would be appropriate.<sup>107</sup> One commenter suggested that in the absence of clarification, the more comprehensive carve-out financial statements may be less commonly used,<sup>108</sup> while another commenter recommended that the Commission codify certain staff practices<sup>109</sup> as they relate to presenting carve-out financial statements.<sup>110</sup>

### **c. Final Amendments**

We are adopting amendments to our rules to permit registrants to provide audited annual and unaudited interim abbreviated financial statements substantially as proposed, with certain modifications described below. Recognizing the difficulty registrants face in obtaining and the cost of preparing Rule 3-05 Financial Statements in these circumstances, we believe permitting

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<sup>105</sup> See letter from GT.

<sup>106</sup> See letter from DT. Another commenter recommended that the Commission also permit registrants to exclude any remaining amounts classified as other income or other expense, subject to the same or similar requirements. See letter from IMA.

<sup>107</sup> See letters from BDO, CAQ, Crowe, DT, EY, GT, PWC, and RSM. Neither our proposal nor the final rule addresses carve-out financial statements. “Carve-out financial statements” is a generic term used to describe separate financial statements that are derived from the financial statements of a larger parent company. They are often differentiated from abbreviated financial statements in that reasonable allocations of corporate overhead expenses can be made such that the underlying preparation issues involve the scope of the businesses to be included in the historical financial statements, not whether financial statements can be prepared.

<sup>108</sup> See letter from DT.

<sup>109</sup> See FRM *supra* note 94 at Section 2065; 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*.

<sup>110</sup> See letter from GT.

abbreviated financial statements coupled with the additional required disclosures appropriately balances the cost of preparing the financial disclosures with the protection of investors.

The following chart compares our proposal to the final rules.

	Proposed	Adopted
Qualifying conditions	The business constitutes less than substantially all of the assets and liabilities of the seller.	The total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20 percent or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year.
	The business was not a separate entity, subsidiary, segment, or division during the periods for which the acquired business financial statements would be required.	The acquired business was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable), 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.	No substantive change.
	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.	No substantive change.
Presentation requirements	The balance sheet may be a statement of assets acquired and liabilities assumed.	No substantive change.
	The statement of comprehensive income may be a statement of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) if certain presentation requirements are met.	No substantive change. The title of the statement of comprehensive income must be appropriately modified to indicate it omits certain expenses.

	<p>Corporate overhead expenses may be excluded from the statement of comprehensive income provided that the statement does 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.</p>	<p>The statement of comprehensive income must include expenses incurred by or on behalf of the acquired business during the pre-acquisition financial statement periods to be presented including, but not limited to, costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development, but may otherwise omit corporate overhead expenses.</p>
	<p>Interest expense may be excluded from the statements if the debt to which the interest expense relates will not be assumed by the registrant or its subsidiaries consolidated.</p>	<p>No substantive change.</p>
	<p>Income tax expense may be omitted.</p>	<p>No substantive change.</p>
	<p>The notes to the financial statements include the following additional 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; and  (iv) Information about the business’s operating, investing and financing cash flows, to the extent available.</p>	<p>No substantive change.</p>

We are persuaded by commenter feedback that a condition focused on whether the acquired business is a small portion of the selling entity would be a more appropriate standard than “less than substantially all of the assets and liabilities of the seller” for permitting the use of

abbreviated financial statements. A “small portion of the selling entity” standard would help ensure that abbreviated financial statements are not used when the component of the selling entity acquired is sufficiently large such that presentation of the seller’s financial statements, along with pro forma financial information that removes the portion of the seller not acquired, would best inform investors about the business acquired. We are also persuaded that absent any threshold, there would likely be divergence in how registrants interpret “small portion of the selling entity.”<sup>111</sup> Accordingly, we are adopting amendments to replace the proposed “less than substantially all of the assets and liabilities of the seller” condition for use of abbreviated financial statements with a condition that “the total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20 percent or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year.”<sup>112</sup> We believe that 20 percent or less is an appropriate level for identifying when the acquired business is a small portion of the selling entity because, at that level, it is reasonable to expect that expenses would not be fully allocated and that comparisons of total assets and total revenues will be sufficient for this purpose.<sup>113</sup> A 20 percent threshold also is generally consistent with the staff’s granting of relief pursuant to Rule 3-13 in such situations. In situations where an acquired business exceeds the 20 percent threshold but the registrant nonetheless confronts unique challenges in making the relevant allocations necessary to provide Rule 3-05 Financial Statements, the registrant could continue to seek relief pursuant to Rule 3-13.

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<sup>111</sup> See letter from GT.

<sup>112</sup> See amended Rule 3-05(e)(1)(i).

<sup>113</sup> A comparison of pre-tax income will not ordinarily be meaningful because pre-tax income will seldom be readily determinable for acquisitions of this nature.

Of the various terms recommended by commenters for definition or clarification, we were persuaded that the term “segment” should be further refined to clarify that it refers to an “operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable)” rather than, for example, a reportable segment. We note that many of the other terms cited by commenters have long been associated with the historical practice of using abbreviated financial statements and we believe their meanings are generally understood. To the extent registrants have unique circumstances relating to the application of these terms in the context of a transaction, the registrant could seek relief pursuant to Rule 3-13. We are therefore not persuaded that further clarification is necessary in order to implement proposed Rule 3-05(e).

We believe that the qualifying conditions for use of abbreviated financial statements included in the final rule are appropriate to delineate the circumstances for their permitted use and provide an appropriate balance between investor protection and capital access. As noted above, one commenter requested clarity on the expenses to be included in abbreviated financial statements. In response to this comment, we have sought to improve the description of required expenses by:

- Reorganizing the rule text into “qualifying conditions” and “presentation requirements” and shortening the introductory paragraph;<sup>114</sup>
- Clarifying that the expenses required in the statement of comprehensive income must include expenses incurred by or on behalf of the acquired business during the pre-acquisition financial statement periods to be presented, but may otherwise omit corporate overhead expense, interest expense for debt that will not be assumed by the registrant or its subsidiaries consolidated, and income tax expense; and

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<sup>114</sup> See amended Rule 3-05(e).

- Adding cost of sales or services and depreciation and amortization expense to the list of expenses that must be included in abbreviated financial statements and clarifying that it is an illustrative list.<sup>115</sup>

As previously noted, neither our proposal nor the final rule address “carve-out financial statements.” Given that carve-out financial statements are not addressed by this release and because issues relating to carve-out financial statements may require unique judgments that involve the balance between investor protection and capital access, we believe questions relating to carve-out financial statements are best addressed on the basis of their unique facts and circumstances through the staff consultation process.<sup>116</sup>

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

Rule 3-05 applies to acquisitions of a significant business<sup>117</sup> that includes oil and gas producing activities.<sup>118</sup> However, Rule 3-05 does not specify industry-specific disclosures regarding 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>119</sup> on an unaudited basis for each full year of operations presented for the acquired business.

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<sup>115</sup> The title of the statement of comprehensive income must be appropriately modified to indicate it omits certain expenses.

<sup>116</sup> See Rule 3-13, *supra* note 58.

<sup>117</sup> See Rule 11-01(d).

<sup>118</sup> See the definition of “oil and gas producing activities” at 17 CFR 210.4-10(a)(16).

<sup>119</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 94 at Section 2065.12. These supplemental disclosures are a subset of those required in the financial statements of publicly traded companies with significant oil- and gas-producing activities and provide additional context for those financial statements.

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, but does not constitute a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable), 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 registrant.<sup>120</sup> In these circumstances when certain criteria are met, Commission staff, pursuant to Rule 3-13 and delegated authority, has permitted registrants to provide abbreviated financial statements that consist of income statements modified to exclude expenses that are not expected to be comparable to future operations.<sup>121</sup>

**a. Proposed Amendments**

The Commission proposed Rule 3-05(f) to codify the reporting practices for oil and gas producing activities by requiring certain ASC 932 Disclosures on an unaudited basis for each full year of operations presented for the acquired business. In addition, where the oil and gas producing 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 registrant, the Commission

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<sup>120</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>121</sup> See FRM *supra* note 94 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.

proposed to permit registrants to provide abbreviated financial statements that consist of income statements modified to exclude expenses not comparable to future operations.

**b. Comments**

One commenter specifically supported the codification of current practices relating to a business that includes oil and gas producing activities as proposed<sup>122</sup> while another commenter supported the proposal generally but suggested removing one of the conditions.<sup>123</sup> No commenters opposed the proposed amendments.

**c. Final Amendments**

We are adopting the amendments substantially as proposed. Specifically, for a significant acquired business that includes *significant oil- and gas-producing activities* (as defined in the FASB ASC Master Glossary),<sup>124</sup> Rule 3-05 Financial Statements must include certain ASC 932 Disclosures, which may be presented as unaudited supplementary information for each full year of operations presented for the acquired business.<sup>125</sup> Additionally, Rule 3-05 Financial Statements may consist of only audited statements of revenues and expenses that exclude depreciation, depletion 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*

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<sup>122</sup> See letter from KPMG. KPMG also suggested permitting abbreviated financial statements for businesses that service oil and gas fields (e.g., the acquisition of a midstream facility or storage facility).

<sup>123</sup> See letter from Cravath. Cravath recommended removing the condition that the business “was not a separate entity, subsidiary, segment, or division.”

<sup>124</sup> We are adopting this definition of *significant oil- and gas-producing activities* to be consistent with current practice. Accordingly, the FASB’s threshold for determining when ASC 932 Disclosures of unaudited supplemental information is required will be applied in determining specified disclosures in ASC 932-235-50 for purposes of Rule 3-05 Financial Statements, even if the acquired business is not a publicly-traded company.

<sup>125</sup> See ASC 932-235-50-3 through 50-11 and ASC 932-235-50-29 through 50-36.

*activities* (as defined in §210.4-10(a)(16)), and (2) the qualifying conditions for abbreviated financial statements described in Section II.A.3.c above are met.<sup>126</sup> In these circumstances, the footnote disclosures described in Section II.A.3.c above must also be provided.<sup>127</sup> As discussed in the Proposing Release, we believe that codifying these practices provides clarity for registrants regarding the application of Commission rules in these circumstances, which we believe will facilitate compliance to the benefit of both registrants and investors.<sup>128</sup>

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

### **a. Proposed Amendments**

The Commission proposed several revisions to Rule 3-05 and Article 11 to clarify when Rule 3-05 Financial Statements and pro forma financial information are required and to update the language in the rules to take into account concepts that have developed since their original adoption over 30 years ago.

### **b. Comments**

Commenters were generally supportive of the proposed changes.<sup>129</sup> Some commenters sought clarification that the “applicable independence standards” in the proposed requirement that financial statements be “prepared 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)” would be those related to the auditing standards under

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<sup>126</sup> We were not persuaded by the commenter suggesting the condition that the business “was not a separate entity, subsidiary, segment, or division” should be removed. We believe this condition can be indicative of circumstances where reasonable allocations necessary to prepare financial statements can be made.

<sup>127</sup> The amendments revise proposed Rule 3-05(f) to simplify its text and to reference the applicable qualifying and presentation conditions of amended Rule 3-05(e).

<sup>128</sup> See Section II.A.4 of the Proposing Release.

<sup>129</sup> See, e.g., letters from Cravath and Eli Lilly.

which the required financial statements of the acquired or to-be-acquired business were audited.<sup>130</sup> One commenter further recommended clarifying whether the reference to “filed” in the phrase in proposed Rule 11-01(b)(3) “most recent annual consolidated financial statements filed at or prior to the date of acquisition or disposition” is the same as “required to be filed” and how the phrase “most recent annual financial statements of each such business” applies to nonpublic acquired or to-be-acquired businesses.<sup>131</sup> Another commenter recommended that the timing of the pro forma financial information be accelerated to a date closer to when the deal is announced to the public.<sup>132</sup> Another commenter recommended that the “significant subsidiary” definition should explicitly state that the amounts used for testing should be derived from “consolidated” financial statements of the tested subsidiary and of the registrant.<sup>133</sup>

### **c. Final Amendments**

We are adopting the amendments substantially as proposed with some additional changes reflecting the suggestions of commenters and our further consideration of the proposals.

Specifically, we are amending Rule 3-05 and Article 11, as proposed, to:

- 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

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<sup>130</sup> See letters from CAQ, Crowe, and RSM. See also letters from KPMG (recommending “independence standards would be those applicable under the auditing standards used to perform the audit of the acquired or to be acquired business”) and Deloitte (recommending clarification as to whether “applicable independence standards” refers to any independence standards other than those described in either Article 2, *Qualifications and Reports of Accountants*, or the independence standards of the AICPA).

<sup>131</sup> See letter from Deloitte.

<sup>132</sup> See letter from CFA (recommending four business days after the occurrence of the event with the ability to extend the deadline to a maximum of 30 days in order to balance the compliance burden with the imperative of timely disclosure to the market). Item 9.01 of Form 8-K currently permits up to approximately 75 days after consummation of an acquisition.

<sup>133</sup> See letter from Eli Lilly.

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>134</sup> and

- Provide in Rules 3-05(b)(3) and 11-01(b)(3)(i)(C) 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>135</sup>

We additionally are updating the terminology and language used by revising Rule 3-05 and Article 11, as proposed, to:

- Clarify that “financial statements” need not include related schedules specified in 17 CFR 210.12 (“Article 12”);<sup>136</sup>
- Clarify that a “business” that is a real estate operation is subject to Rule 3-14 instead of Rule 3-05;
- Clarify in Rule 3-05(a)(2)(ii) that Rule 3-05 applies when the fair value option is used in lieu of the equity method to account for an acquisition because the disclosure required by

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<sup>134</sup> We are amending 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), the explanation that the acquisition of a business encompasses the acquisition of an interest in a business accounted for by the equity method was moved from Rule 3-05(a)(1)(i) to Rule 3-05(a)(2)(ii).

<sup>135</sup> 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. We are establishing by rule that registrants are permitted, rather than required, to use the Form 10-K filed after consummation to measure significance in this circumstance to avoid creating an incentive for registrants to delay the filing of their Form 10-K.

<sup>136</sup> Item 9.01(a)(2) of Form 8-K already provides that supporting schedules of financial statements need not be filed and the staff further applies this approach to acquired business financial statements required in registration statements and proxy statements. *See* FRM *supra* note 94 at Section 2005.2.

U.S. GAAP on a post-acquisition basis, and related disclosure provided pursuant to Rules 3-09 and 4-08(g), includes summarized financial information or separate financial statements of the business after the acquisition;

- Replace the term “furnish” with “file” to make clear that the information required by Rule 3-05 and Article 11 must be filed with the Commission;<sup>137</sup>
- Clarify that references to “this regulation” in Rule 3-05, Rule 3-14, and Rule 6-11 include the independence standards in Rule 2-01 unless the business is not a registrant, in which case the applicable independence standards would apply;
- Replace references to the terms “business combination” and “combination between entities under common control” with the term “business acquisition” to make clear that Rule 3-05 and Article 11 are not limited to “business combinations” as that term is used in U.S. GAAP and IFRS-IASB;<sup>138</sup> and
- Replace the term “majority-owned” 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>139</sup>

Finally, we are adopting the following clarifying amendments, as proposed, to Rules 1-02(w), 3-05, Form 8-K and Article 11 to:

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<sup>137</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, the Commission made no distinction between “furnished” and “filed.” See Rule 3-05 Adopting Release.

<sup>138</sup> We similarly are adopting a conforming amendment to the Instruction to Item 9.01 of Form 8-K.

<sup>139</sup> Rule 3-05 uses the term “subsidiaries consolidated” to conform to the term used elsewhere in Regulation S-X. See, e.g., Rule 1-02(w), Rule 3-01, and Rule 3-02. We additionally are replacing the term in Item 2.01 of Form 8-K.

- Replace the reference to “total assets” of the tested subsidiary in the Asset Test with the tested subsidiary’s “consolidated total assets” as that term conveys more accurately the amount to be used in the Asset Test;<sup>140</sup>
- Replace the term “shall” with clearer language, such as by indicating when a registrant “must” file or disclose certain information;
- Revise proposed Rule 11-01(b)(3) to:
  - Simplify its organization;
  - Clarify that it does not apply to the continuous real estate offerings described in new Rule 11-01(b)(4);<sup>141</sup>
  - Replace the reference to “filed” with “required to be filed” to more clearly reflect existing practice;<sup>142</sup>
  - Remove the reference to related real estate operations for combined pre-acquisition financial statements;<sup>143</sup> and
  - Clarify what financial statements of a nonpublic acquired or to-be-acquired business must be used in the significance determination;<sup>144</sup>

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<sup>140</sup> Consistent with a comment we received, we are adopting this change to clarify that all amounts used in the significant subsidiary tests that are derived from financial statements of the tested subsidiary and the registrant should be based on consolidated amounts. *See supra* note 133. The Investment Test and Income Test, as proposed, already specified the requirement to use consolidated amounts.

<sup>141</sup> *See* Section II.C.6. Proposed Rule 3-14(b)(2)(iii) was relocated and relabeled as Rule 11-01(b)(4).

<sup>142</sup> Use of “required to be filed” would also clarify that the 15-day extension provided by Form 12b-25 does not serve to revert the significance determination to an earlier year during the 15-day extension.

<sup>143</sup> The reference to related real estate operations is not necessary in this context because only a modified Investment Test is required for significance testing of these acquisitions.

<sup>144</sup> The amended rules replace the phrase “most recent annual financial statements of each such business” with “the business’s pre-acquisition or pre-disposition financial statements for the same fiscal year as the registrant or, if the fiscal years differ, the business’s most recent fiscal year that would be required if the business had the same filer status as the registrant.”

- Revise Instruction 4 to Item 2.01 of Form 8-K to include the same clarification of the scope of Rule 3-05 with regards to interests in businesses that will be accounted for under the equity method or, in lieu of the equity method, the fair value option;<sup>145</sup> and
- Conform technical terminology inconsistencies throughout the rules.<sup>146</sup>

We are not adopting modifications to clarify, as requested by commenters, the “applicable independence standards” in the proposed requirement that financial statements be “prepared 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)” because the independence standards applicable for a particular audit are not necessarily linked to the auditing standards used for such an audit. For example, for purposes of auditing non-issuer Rule 3-05 or Rule 3-14 Financial Statements, an auditor may follow AICPA auditing and independence standards but also may elect to perform the audit under PCAOB auditing standards. Our amendments are not intended to change practice by referring to “applicable independence standards,” but rather to acknowledge that for an acquired or to be acquired business that is a non-issuer, an auditor is not required to follow the independence standards in Rule 2-01 for purposes of auditing Rule 3-05 and Rule 3-14 Financial Statements. As a result, if the acquired or to be acquired business is not an issuer, the auditor should look to the applicable ethics and independence standards that would apply in issuing the audit report for such business

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<sup>145</sup> Item 2.01 of Form 8-K does not explicitly clarify the treatment of interests in businesses that will be accounted for under the equity method or, in lieu of the equity method, the fair value option. However, the determination of whether an acquisition involves a business is consistent between Item 2.01 of Form 8-K and Rule 3-05, because both Instruction 4 to Item 2.01 of Form 8-K and Rule 3-05(a)(2)(ii) refer to the same definition of a business in Rule 11-01(d), and the requirements of Item 2.01 of Form 8-K are linked to the requirements of Rule 3-05 through Item 9.01 of Form 8-K. This amendment conforms Item 2.01 of Form 8-K to include the additional clarification from Rule 3-05.

<sup>146</sup> For example, proposed Rule 3-05(c) has been amended to include a reference to the definition of a foreign business in Rule 1-02(l) to be consistent with proposed Rule 3-05(d) which already included the reference.

in satisfying the audit requirement for purposes of the Rule 3-05 and Rule 3-14 Financial Statements.

We are also not adopting requirements to accelerate the timing of providing pro forma financial information, as one commenter suggested. For acquisitions, pro forma financial information is based on the audited financial statements of the acquired business for periods prior to the acquisition of the business by the registrant. In these circumstances, our requirements provide additional time for registrants to obtain acquired business pre-acquisition historical financial statements, which we believe should also continue to extend to pro forma financial information.<sup>147</sup>

## **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>148</sup> Rule 3-05 similarly permits the use of IFRS-IASB in financial statements of foreign businesses. However, 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 are required to be reconciled to U.S. GAAP even if the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB.<sup>149</sup>

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<sup>147</sup> See, e.g., Item 9.01 of Form 8-K.

<sup>148</sup> See 17 CFR 210.4-01.

<sup>149</sup> See Item 17 of Form 20-F and *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”).

Further, while the definitions of “foreign private issuer”<sup>150</sup> and “foreign business”<sup>151</sup> have similarities, they have different ownership requirements such that a business could qualify to be a “foreign private issuer” if it were a registrant, but not qualify to be a “foreign business” when it is acquired by a registrant. In this circumstance, a registrant acquiring such a business is not permitted to present Rule 3-05 Financial Statements of the acquired business prepared in accordance with IFRS-IASB, even when those financial statements are already available and even though the acquired business could present IFRS-IASB financial statements if it were a registrant. Instead, the Rule 3-05 Financial Statements must be prepared in accordance with U.S. GAAP.<sup>152</sup>

**a. Proposed Amendments**

The Commission proposed to permit Rule 3-05 Financial Statements for an acquired foreign business prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP if the registrant is a foreign private issuer that prepares its financial statements using IFRS-IASB. The Commission also proposed to permit Rule 3-05 Financial Statements to be

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<sup>150</sup> See Securities Act 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 percent 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 percent 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>151</sup> See 17 CFR 210.1-02(l). The term “foreign business” means a business that is majority owned by persons who are not citizens or residents of the United States and is not organized under the laws of the United States or any state thereof, and either: (1) More than 50 percent of its assets are located outside the United States; or (2) The majority of its executive officers and directors are not United States citizens or residents.

<sup>152</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 1994 Acquired Foreign Business Release.

prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would be a foreign private issuer if it were a registrant.

## **b. Comments**

Commenters generally supported the proposal,<sup>153</sup> with some recommending providing additional relief by allowing reconciliation to IFRS-IASB rather than U.S. GAAP for a business that prepares its financial statements using home-country GAAP and does not meet the definition of a foreign business but that would be a foreign private issuer if it were a registrant.<sup>154</sup> One commenter additionally suggested that the Commission provide guidance on the applicability of IFRS 1, *First-time Adoption of IFRS*,<sup>155</sup> and accommodations under Form 20-F when reconciling to IFRS-IASB.<sup>156</sup> Irrespective of the GAAP being applied or reconciled to, some commenters recommended that the Commission consider permitting required audit reports on the financial statements of acquired foreign businesses to be prepared in accordance with International Standards on Auditing (“ISAs”) issued by the International Auditing and Assurance Standards Board.<sup>157</sup>

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<sup>153</sup> See, e.g., letters from Chris Barnard (“Barnard”), Cravath, DT, NAREIT, Nasdaq, and PWC.

<sup>154</sup> See, e.g., letters from BDO, CAQ, DT, EY, KPMG, and RSM. Some of these commenters recommended simplifying the rules by expanding proposed Rule 3-05(c) and eliminating proposed Rule 3-05(d). See, e.g., letters from CAQ, EY, KPMG, and RSM.

<sup>155</sup> IFRS 1 provides recognition, measurement, and disclosure requirements, as well as certain transitional exceptions, for entities that present IFRS-IASB financial statements for the first time.

<sup>156</sup> See letter from DT. DT indicated that certain accommodations offered under Form 20-F, Item 17, such as to not remove the effects of inflation accounting pursuant to Item 17(c)(2)(iv)(2) when the conditions of IAS 29, *Reporting in Hyperinflationary Economies*, are not met, or to not reconcile the effects of proportionate consolidation for investments in joint ventures pursuant to Item 17(c)(2)(vii), may be inconsistent with IFRS-IASB requirements.

<sup>157</sup> See letters from Barnard, BDO, KPMG, and PWC.

### c. Final Amendments

We are adopting the amendments substantially as proposed, but with some modifications after consideration of the comments received. We are amending the rules in order to increase the consistency between the basis of accounting used by acquired businesses and foreign private issuers, as well as to permit acquired businesses and registrants to avoid unnecessary costs, such as one-time presentations of the U.S. GAAP reconciling information where such information would not be material to investors.

Specifically, we are adopting the proposed amendments to Rule 3-05(c) to permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile Rule 3-05 Financial Statements of foreign businesses prepared using home country GAAP to IFRS-IASB rather than U.S. GAAP because this will provide more comparable information and better facilitate analysis of the financial statements. The reconciliation to IFRS-IASB is required generally to follow the form and content requirements in Item 17(c) of Form 20-F.

Additionally, we are adopting, as proposed, Rule 3-05(d) to permit Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP<sup>158</sup> if the acquired business would qualify as a foreign private issuer if it were a registrant. As discussed in the Proposing Release, we believe financial statements prepared in accordance with IFRS-IASB provide sufficient information for investors for this purpose.<sup>159</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.

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<sup>158</sup> Under the 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>159</sup> See Section II.A.6.a. of the Proposing Release.

After considering comments received on the proposals, we are modifying the proposed amendments to additionally permit an acquired business that would qualify as a foreign private issuer if it were a registrant to reconcile to IFRS-IASB rather than U.S. GAAP when the registrant is a foreign private issuer that uses IFRS-IASB. We agree with commenters that reconciliation to IFRS-IASB will provide more comparable information and better facilitate analysis of the financial statements in this circumstance as well.

In response to comments, we are adopting two additional modifications to the proposed amendments to clarify that:

- IFRS 1, *First-time Adoption of IFRS*, will be applicable when reconciling to IFRS-IASB; and
- Form 20-F accommodations that are inconsistent with IFRS-IASB will not be available when reconciling to IFRS-IASB.

We believe it is appropriate to specify that IFRS 1 will be applicable when reconciling Rule 3-05 Financial Statements to IFRS-IASB, because a business that is reconciling to IFRS-IASB for the first time will face many of the same challenges in determining the relevant financial statement amounts as it would if it were directly presenting its financial statements under IFRS-IASB for the first time. Similarly, we believe it is appropriate to specify that Form 20-F accommodations that are inconsistent with IFRS-IASB will not be available when reconciling to IFRS-IASB. These accommodations, such as to not remove the effects of inflation accounting when the conditions of IAS 29 are not met or to not reconcile the effects of proportionate consolidation in joint ventures,<sup>160</sup> were adopted in the context of reconciling to U.S. GAAP rather than IFRS-IASB. They were also adopted when the range of accounting

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<sup>160</sup> See *supra* note 156.

practices around the world was wider than it is today and before IFRS-IASB was established in its current form. We believe that use of accommodations that are inconsistent with IFRS-IASB would not result in sufficient information for investors in this context.

We are not combining proposed Rule 3-05(c) and 3-05(d) as suggested by some commenters. Rule 3-05(c) addresses the financial statement requirements for an acquired business that meets the definition of a foreign business. Rule 3-05(d) addresses the financial statement requirements for an acquired business that does not meet the definition of a foreign business but that would be a foreign private issuer if it were a registrant. We believe that separate paragraphs will permit registrants to more easily determine which requirements apply to their acquired businesses. Separate paragraphs will also help to clarify that foreign businesses under Rule 3-05(c) may apply the other applicable accommodations in Form 20-F while the businesses that fall under Rule 3-05(d) cannot.<sup>161</sup>

Finally, we are not adopting revisions to accept ISAs in audit reports on Rule 3-05 Financial Statements of foreign businesses as suggested by some commenters. Use of ISAs in Commission filings would involve broader considerations than Rule 3-05 Financial Statements, potentially including the appropriateness of their use for audits of foreign private issuer financial statements. We believe such an approach would require a thorough evaluation of the appropriateness of the use of ISAs and is beyond the scope of these amendments.

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<sup>161</sup> For example, foreign businesses under Rule 3-05(c) may apply the age of financial statement requirements in Item 8 of Form 20-F, and may apply the accommodation in Item 17(c)(2)(v) of Form 20-F that allows them to not reconcile their financial statements to U.S. GAAP if the significance of the foreign business is below 30 percent.

## 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. Part F/S of Form 1-A (“Part F/S”)<sup>162</sup> directs an issuer relying on Regulation A<sup>163</sup> to present financial statements of businesses acquired or to be acquired,<sup>164</sup> as specified by Rule 8-04, but permits the periods presented to be the shorter of those applicable to issuers relying on Regulation A and the periods specified by Article 8.<sup>165</sup>

### a. Proposed Amendments

The Commission proposed to revise Rule 8-04 to reference 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>166</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 issuers relying on Regulation A

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<sup>162</sup> 17 CFR 239.90.

<sup>163</sup> 17 CFR 230.251 through 263.

<sup>164</sup> See paragraph (b)(7)(iii) of Part F/S of Regulation A.

<sup>165</sup> See paragraph (b)(7) of Part F/S of Regulation A.

<sup>166</sup> Rule 3-05(b)(1) currently requires financial statements specified in Rule 3-01 and 3-02 for the business to be acquired. Similarly, Rule 3-05(b)(2) also references Rule 3-01 and 3-02. Under the proposal, smaller reporting companies would apply Rule 3-05 but would substitute Rule 8-02 and Rule 8-03, as applicable, wherever Rule 3-05 references Rule 3-01 and 3-02. In this way, the proposal was 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 Rule 8-01 Preliminary Note 2 to Article 8) to businesses acquired by smaller reporting companies.

would continue to be permitted to present the shorter of the periods applicable under Regulation A and the periods specified by Article 8.<sup>167</sup>

### **b. Comments**

A few commenters provided comments specifically related to smaller reporting companies and smaller issuers.<sup>168</sup> One commenter expressly supported the proposal to conform the rules applicable to smaller reporting companies to the generally applicable rules.<sup>169</sup> Other commenters offered specific recommendations relating to smaller registrants<sup>170</sup> or generally suggested the Commission consider whether issuers relying on Regulation A warrant different treatment.<sup>171</sup>

### **c. Final Amendments**

We are adopting the amendments substantially as proposed. We are revising Rule 8-04 to reference 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. These revisions should ease compliance burdens and clarify the application of our rules for smaller

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<sup>167</sup> Additionally, the proposed revisions would have expressly permitted smaller reporting companies and issuers relying on Regulation A 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 proposed 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 and issuers relying on Regulation A 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>168</sup> *See, e.g.*, letters from BDO, EY, MTBC, and RSM. *See also* SBCFAC Recommendations.

<sup>169</sup> *See* letter from BDO.

<sup>170</sup> *See* letter from MTBC (recommending that smaller registrants only apply the revenue component of the Income Test).

<sup>171</sup> *See* SBCFAC Recommendations (recommending that the Commission continue to look at "Regulation A companies and whether they warrant different treatment under these rules").

reporting companies and issuers relying on Regulation A by focusing them on the more complete and better understood provisions of Rule 3-05. They will also expressly permit smaller reporting companies and issuers relying on Regulation A to omit historical acquired business financial statements if the acquired business has been included in the registrant's results for either nine months or a complete fiscal year, depending on significance.

We are also revising Rule 8-01 as proposed, to add a paragraph expressly permitting application of Rule 3-06 to the preparation of financial statements of smaller reporting companies and issuers relying on Regulation A<sup>172</sup> and to amend the instruction in Item 9.01 of Form 8-K to include references to Rule 8-04 in order to conform the instruction to the text of Item 9.01, which already addresses the rules applicable to smaller reporting companies.

We considered whether issuers relying on Regulation A should be treated differently or whether smaller registrants should be subject to further differentiated requirements, such as only complying with the revenue component of the Income Test, as one commenter suggested. We determined not to further differentiate disclosure for issuers relying on Regulation A and smaller reporting companies because we think the rules as adopted result in important investor information that we do not believe should be further reduced or modified.<sup>173</sup> We believe that existing accommodations should offset some of the burden associated with the disclosures that would be required by the rules. For example, Rule 8-01(b) provides, with limited exceptions,

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<sup>172</sup> In addition, we are revising Rule 8-01 to remove the reference to the instruction relating to pro forma presentation requirements. *See* Section II.D.3. In a non-substantive change from our proposal, we are also renaming Rule 8-01 "General Requirements for Article 8" and re-designating Notes 1 through 5 of Rule 8-01 as paragraphs (a) through (e).

<sup>173</sup> For example, we believe it is important that smaller reporting companies and issuers relying on Regulation A be required to provide pro forma financial information when consummation of other transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors. *See Section II.D.3.* We also note that significance tests are not one-size-fits-all tests, but instead contemplate the unique facts and circumstances of a registrant or issuer because they measure significance of the acquired or disposed business relative to the registrant or issuer.

that smaller reporting companies electing to prepare their financial statements with the form and content required by Article 8 need not apply the other form and content requirements in Regulation S-X, and Form 1-A Part F/S provides that, in certain circumstances, financial statements of businesses acquired or to be acquired may be unaudited, may be for shorter periods than provided in Rule 8-04, and need not be updated if the most recent annual or interim balance sheet is not older than nine months. Further, as discussed below, the final rules contain a number of provisions that, while applicable to issuers of all sizes, should help ease the burden of providing the required financial information for smaller reporting companies and issuers relying on Regulation A.<sup>174</sup>

As revised, Rule 8-04 continues to require up to two years of acquired business historical financial statements. Additionally, and in accordance with current practice, the revised rule expressly permits 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.<sup>175</sup> We are also adding references to Rule 8-04 in Rule 3-06 and to Rule 3-06 in Article 8, as proposed, to expressly permit smaller reporting companies to file audited 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.

The amendments also provide that a smaller reporting company is 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

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<sup>174</sup> For example, we believe the significance tests we are adopting will provide more meaningful indicators of significance and mitigate anomalous significance results.

<sup>175</sup> See further discussion of omission of Rule 3-05 Financial Statements in Section B.1. above.

prospectus supplement, rather than 74 days prior to the effective date of the registration statement as under current Rule 8-04(c)(4).<sup>176</sup> We believe it is appropriate to consistently look to the date of the final prospectus or prospectus supplement for registrants,<sup>177</sup> as Rule 3-05 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>178</sup> We are also making conforming changes to Rule 8-05 for smaller reporting companies to be consistent with the changes we are making to Article 11.<sup>179</sup>

## **B. 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**

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.

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. The staff has historically not objected, however, to registrants reducing the Rule 3-05 Financial Statement

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<sup>176</sup> See proposed Rule 3-05(b)(4)(i)(B).

<sup>177</sup> See 1996 Streamlining Release *supra* note 24 (noting that the date of an offering is specified as the date of the final prospectus or prospectus supplement relating to the offering).

<sup>178</sup> See General Instruction I.B.6 of Form S-3 and *Amendments to Smaller Reporting Company Definition*, Release No. 33-10513 (June 28, 2018) [83 FR 31992 (July 10, 2018)].

<sup>179</sup> See Section II.D.3 below.

periods presented by the equivalent period that the acquired business is included in the registrant's post-acquisition audited results.<sup>180</sup>

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 meeting at least one of the significance tests set forth in Rule 1-02(w) at the 80 percent level at the date of the acquisition would require the registrant to continue to file the financial statements of the acquired business. 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>181</sup>

**a. Proposed Amendments**

The Commission proposed 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. The Commission also proposed to eliminate the "major significance" exception.

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<sup>180</sup> The staff's position has been 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 results. See FRM *supra* note 94 at Section 2030.4 "Initial Registration Statements – Using Pre-Acquisition and Post-Acquisition Audited Results."

<sup>181</sup> See, e.g., FRM *supra* note 94 at Section 2040.2 "'Major Significance' and Previously Filed Acquiree Financial Statements."

## b. Comments

Commenters generally supported the proposed amendments.<sup>182</sup> One commenter, however, encouraged the Commission to seek additional input and consider whether the proposed amendments would provide investors with sufficient information and whether additional financial statements may be necessary above a certain significance threshold.<sup>183</sup>

A number of commenters recommended permitting registrants to exclude separate financial statements once the acquired business has been included in the post-acquisition audited financial statements for at least nine months.<sup>184</sup> Commenters analogized to the Rule 3-06 requirements, noting that Rule 3-06 only requires nine months of pre-acquisition audited financial statements for an acquisition that exceeds 20 percent, but does not exceed 40 percent, significance.<sup>185</sup> In expressing support for using nine months, one of these commenters noted that the Commission could consider a requirement to disclose any material information impacting

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<sup>182</sup> See, e.g., letters from Bass Berry, BDO, CAQ, Cravath, DT, Eli Lilly, FEI, KPMG, Pillsbury Winthrop Shaw Pittman, LLP, PWC, and Nasdaq.

<sup>183</sup> See letter from GT. This commenter cited an example where an initial public offering registrant consummates a very large acquisition in the year prior to the most recently completed fiscal year for which financial statements are being provided for the registrant. The commenter noted that while the registrant would be required to provide its historical financial statements for two years, the acquired business's financial statements would be limited to the period for which it is included in the registrant's post-acquisition results. The commenter further observed that, in its experience, disclosure pursuant to Regulation S-K, Item 303, *Management's discussion and analysis of financial condition and results of operations*, may not clearly isolate the effects of the acquisition on results of operations. The commenter suggested as an example that the Commission could consider requiring an initial public offering registrant to provide financial statements for the same number of periods as required in subsequent Securities Act and Exchange Act filings or for the same number of periods as the 50 percent threshold would require, prior to proceeding with a securities offering.

<sup>184</sup> See, e.g., letters from BDO, CAQ, Crowe, DT, EY, GT, KPMG, PWC, and RSM.

<sup>185</sup> See, e.g., letters from BDO and DT. One of these commenters further noted that staff practice as documented in FRM 2040.2 generally permits omission of previously filed acquired business financial information once it is included in the registrant's post-acquisition results for nine months. See letter from DT. The other commenter recommended allowing omission of pre-acquisition financial statements for businesses that exceed 20 percent, but do not exceed 40 percent, significance once they are included in the registrant's audited post-acquisition results for nine months and for businesses that exceed 40 percent significance once they are included in the registrant's post-acquisition results for a complete fiscal year. See letter from BDO.

any pre-acquisition period that would otherwise be required absent the use of Rule 3-06 to supplement required financial statements.<sup>186</sup>

**c. Final Amendments**

We are adopting revisions substantially as proposed with some modifications in response to comments received. Specifically, we are adopting the proposed elimination of the requirement to include Rule 3-05 Financial Statements in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements. However, in response to comments, we are modifying the requisite time period.

We are persuaded by commenters that our proposal unnecessarily perpetuates existing differences in the length of reporting periods that exist between Rule 3-05 and Rule 3-06 for an acquisition that is at least 20 percent, but not more than 40 percent, significant. One condition in Rule 3-05 for omitting Rule 3-05 Financial Statements is that the acquired business has been included in the registrant's post-acquisition results for a complete fiscal year. However, Rule 3-06 permits the filing of Rule 3-05 Financial Statements covering a period of nine months to satisfy the Rule 3-05 requirement for filing financial statements for a period of one year. While these reporting periods relate to different circumstances, omission under Rule 3-05 as compared to inclusion under Rule 3-06, we do not believe those circumstances are sufficiently different for acquisitions that are at least 20 percent, but not more than 40 percent, significant (*i.e.*, significant at the one year level) to warrant disclosures for different time periods. To provide consistency between the Rule 3-05 and Rule 3-06 requirements, the amendments will allow omission of pre-acquisition financial statements for businesses that exceed 20 percent but do not exceed 40

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<sup>186</sup> See letter from Crowe.

percent significance once they are included in the registrant's audited post-acquisition results for nine months (rather than the proposed complete fiscal year).<sup>187</sup>

Because Rule 3-06 limits the use of a nine month period to financial statements that would otherwise be required for a period of one year, the amendments retain the existing complete fiscal year Rule 3-05 requirement when Rule 3-05 Financial Statements for a period of two years are required (*i.e.*, significance exceeds 40 percent). Specifically, the amendments allow omission of pre-acquisition financial statements for businesses that exceed 40 percent significance once they are included in the registrant's post-acquisition results for a complete fiscal year.

These final amendments also 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. 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 because the post-acquisition results of the combined business are generally not comparable to the pre-acquisition results of the acquired business.<sup>188</sup> Similarly for financial information provided regarding

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<sup>187</sup> Rule 3-06 does not require incremental disclosure in order for the filing of financial statements covering a period of nine months to be deemed to satisfy a requirement for filing financial statements for a period of one year. Because our amendments seek to make Rule 3-05 more consistent with Rule 3-06, the final amendments do not include an incremental disclosure requirement within Rule 3-05 to disclose material information impacting any pre-acquisition period that would otherwise be required absent the use of amended Rules 3-05 and 3-06. However, we observe that existing requirements, such as those in Item 303 of Regulation S-K, *Management's discussion and analysis of financial condition and results of operations*, and Rule 4-01(a) would require such disclosure when it is material to the registrant, and we believe that information would be sufficient for this purpose.

<sup>188</sup> See FRM *supra* note 94 at Section 2030.4. The accommodation provided by Commission staff did not sufficiently ameliorate these effects and often resulted in financial statements of the acquired business that depicted partial, rather than complete, reporting periods that did not coincide with the end of either the acquired business's or the registrant's fiscal periods.

acquisitions of “major significance,” the utility of pre-acquisition periods diminishes over time after the acquired business is reflected in post-acquisition results. Additionally, with electronic filing requirements, which were established after the “major significance” rule, previously filed financial information about the acquired business is readily accessible through the Commission’s EDGAR filing system.

We believe inclusion of post-acquisition results in the registrant’s audited financial statements for the requisite time period should generally provide investors with sufficient information to make informed investment decisions about the registrant. 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 must 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.”<sup>189</sup>

We are not persuaded that additional financial statements of acquired businesses should be provided in initial registration statements when an acquisition is reflected in post-acquisition audited results for nine months when the acquisition is significant at the one year level or included for a complete fiscal year when the acquisition is significant at the two year level. Pre-acquisition financial statements by their nature are less likely to be indicative of the current financial condition, changes in financial condition, and results of operations of the acquired business as they age. If, in an unusual circumstance, pre-acquisition financial statements are necessary for the protection of investors even though the acquired business has been included in the registrant’s post-acquisition results for a complete fiscal year, then Rule 3-13 permits the

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<sup>189</sup> See Rule.4-01(a).

Commission staff by delegated authority to require the filing of the pre-acquisition financial statements.

We also believe that rightsizing our acquired business financial statement requirements appropriately balances the need to provide investors with information necessary for making informed investment decisions with the goal of minimizing compliance costs that can delay or preclude access to public markets, particularly when going public may not have been contemplated at the time an acquisition occurred.<sup>190</sup>

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

A registrant is generally permitted to use pro forma, rather than historical, financial information to test significance of a subsequently acquired business if the registrant made a significant acquisition after the latest fiscal year-end and filed its Rule 3-05 Financial Statements and pro forma financial information on Form 8-K.<sup>191</sup> However, this Form 8-K filing requirement has the practical effect of precluding the use of pro forma financial information that gives effect to a significant acquisition subsequent to the latest fiscal year-end to test significance of a subsequently acquired business when determining Rule 3-05 disclosure requirements in initial registration statements. While Commission staff has considered the results of significance tests using pro forma financial information in considering whether to permit omission or substitution of acquired business financial statements in initial registration statements of registrants growing through acquisition, those circumstances have been limited.<sup>192</sup> Further, Regulation S-X does not

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<sup>190</sup> In adopting these changes, we note that Item 303 of Regulation S-K requires identification of known trends, demand, commitments, events and uncertainties and 4-01(a) of Regulation S-X 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.”

<sup>191</sup> See Rule 3-05(b)(3).

<sup>192</sup> Consistent with the staff’s exercise of delegated authority in response to requests under Rule 3-13, Staff Accounting Bulletin No. 80, *Application of Rule 3-05 in Initial Public Offerings* (“SAB 80”) states that the staff

provide for dispositions of significant businesses to be included in the pro forma financial information used for testing significance of a subsequently acquired or subsequently disposed business.

**a. Proposed Amendments**

For all filings that require Rule 3-05 Financial Statements and Rule 3-14 Financial Statements, the Commission proposed to expand the circumstances in which a registrant can use pro forma financial information for significance testing by permitting 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 certain conditions.

**b. Comments**

Commenters generally supported the amendments.<sup>193</sup> However, one commenter stated that once a registrant chooses to use pro forma financial information for significance testing, the registrant should be required to use the approach consistently until the next annual report on Form 10-K is filed,<sup>194</sup> consistent with current staff guidance.<sup>195</sup>

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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, but the accommodations in SAB 80 are complex and seldom used by registrants.

<sup>193</sup> See letters from Cravath, Eli Lilly, FEI, GT, Nasdaq, and S&C.

<sup>194</sup> See letter from GT. GT additionally recommended that the Commission clarify in the final rules that pro forma financial information used to determine significance may be different from pro forma financial information that was previously filed if it gave effect to other transactions. They also recommended that the Commission clarify how pro forma financial information for previous acquisitions or dispositions be used for determining the significance of subsequent acquisitions or dispositions in connection with an initial registration statement, given that pre-acquisition financial statements and pro forma financial information for the previous transactions could not have been previously filed in the case of a confidential submission and the first public filing of an IPO registration statement.

<sup>195</sup> See FRM *supra* note 94 at Section 2025.3, which indicates registrants should use a consistent approach for determining significance until the filing of the next annual report on Form 10-K.

### c. Final Amendments

We are adopting the amendments substantially as proposed, but with some modifications after consideration of the comments received. Specifically, for filings that require Rule 3-05 Financial Statements and Rule 3-14 Financial Statements, we are amending Rule 11-01(b)(3) 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;<sup>196</sup> and
- The registrant has filed the pro forma financial information required by Article 11 for any such acquired or disposed business.<sup>197</sup>

We additionally are amending Rule 11-01(b)(3) as proposed to add a reference to Rule 11-02(b)(6)(i), but relocating it within amended Rule 11-01(b)(3), to clarify that when determining significance the pro forma financial information must be limited to the applicable amounts that combine the historical financial information of the registrant and the acquired business and Transaction Accounting Adjustments.<sup>198</sup> We also are amending Rule 11-01(b)(3)

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<sup>196</sup> We believe this condition clarifies that if the required Rule 3-05 Financial Statements and pro forma financial information for one or more significant business acquisitions consummated after the registrant's most recently completed fiscal year required to be filed are included in an initial registration statement, then those acquisitions may be included in the pro forma financial information used to measure significance of a business acquired subsequent to those acquisitions for purposes of determining whether Rule 3-05 Financial Statements of the subsequently acquired business, and related pro forma financial information, are required in the initial registration statement.

<sup>197</sup> We are revising 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 are also including in Rule 11-01(b)(3) the statement in the current rule that the tests may not be made by "annualizing" data.

<sup>198</sup> See Section II.D.1.c.

to indicate that the pro forma financial information that is used to measure significance may only give effect to the subsequently acquired or disposed business and may not give effect to Autonomous Entity Adjustments, Management's Adjustments, if any, or other transactions, such as the use of proceeds from an offering. Further, we are persuaded to modify the proposal to clarify that once a registrant uses pro forma financial information to measure significance, it must continue to use pro forma financial information to measure significance until the next annual report on Form 10-K or Form 20-F. This modification will codify current practice,<sup>199</sup> provide for a more relevant indicator of significance, and ensure greater consistency in the significance determinations.

We believe these amendments will 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.

### **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 percent significance, or (2) does not exceed 50 percent 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 17 CFR 230.424(b)) is no more than 74 days after consummation and the financial statements have not been previously filed.<sup>200</sup> However, if the

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<sup>199</sup> See *supra* text accompanying note 195.

<sup>200</sup> See Rule 3-05(b)(4)(i).

aggregate impact of “individually insignificant businesses”<sup>201</sup> acquired since the date of the most recent audited balance sheet filed for the registrant exceeds 50 percent, audited historical pre-acquisition financial statements covering at least the substantial majority of the businesses acquired must be included in a registration statement or proxy statement.<sup>202</sup> Registrants also must provide related pro forma financial information based on the requirements of Article 11.<sup>203</sup>

**a. Proposed Amendments**

The Commission proposed amending Rule 3-05 to no longer require separate financial statements for the majority of the individually insignificant acquired businesses when 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 or not yet required because of the registration (or proxy) statement grace period, exceeds 50 percent. In conjunction with this change, the proposed amendments would require

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<sup>201</sup> In the 1996 Streamlining Release (*see supra* note 24), Rule 3-05 was amended to permit the exclusion of historical financial statements for certain significant acquisitions that did not exceed 50 percent significance. *See* Rule 3-05(b)(4)(i). Commission staff has interpreted “individually insignificant businesses” to include: (a) Any acquisition consummated after the registrant’s audited balance sheet date whose significance does not exceed 20 percent; (b) Any probable acquisition whose significance does not exceed 50 percent; and (c) Any consummated acquisition whose significance exceeds 20 percent, but does not exceed 50 percent, 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 94 at Section 2035.2.

<sup>202</sup> *See* Rule 3-05(b)(2)(i). “Substantial majority” has been applied in practice to be the mathematical majority (*i.e.*, businesses constituting more than 50 percent of the relevant test (investment, asset or income) on which the businesses were determined to be significant in the aggregate) *See* FRM *supra* note 94 at Section 2035.3 “*Financial Statements Required – Mathematical Majority.*”

<sup>203</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.

registrants to provide pro forma financial information depicting the aggregate effects of all such businesses in all material respects. In addition, the proposed amendments would have required pre-acquisition historical financial statements only for those businesses whose individual significance exceeds 20 percent, but that are not yet required to file financial statements.

**b. Comments**

Commenters generally supported the proposal to no longer require Rule 3-05 Financial Statements for businesses whose individual significance does not exceed 20 percent.<sup>204</sup> One commenter recommended the Commission consider including both Rule 3-05 businesses and Rule 3-14 real estate operations when determining the aggregate impact for individually insignificant acquisitions and providing guidance on how to perform the aggregations.<sup>205</sup> Another commenter recommended against including them both together due to the difference in the types of transactions covered.<sup>206</sup>

Some commenters expressed concern that the new requirements could create burdens for registrants relating to the proposed requirements to file financial statements for multiple significant acquisitions or the proposed requirements to provide detailed financial information about individually insignificant acquisitions that may not be readily available or may not have been provided to the registrant during its due diligence.<sup>207</sup> Other commenters expressed concern that requiring pro forma financial information that depicts aggregate impacts in “all material

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<sup>204</sup> See, e.g., letters from Cravath, DT, Eli Lilly, FEI, and GT.

<sup>205</sup> See letter from GT.

<sup>206</sup> See letter from Cravath.

<sup>207</sup> See letters from GT and DT. See also letter from Cravath (recommending retaining an option permitting a registrant to include a majority of the acquired businesses in the pro forma presentation or alternatively only requiring historical pre-acquisition financial statements and pro forma financial information if the individually insignificant businesses together exceed 50 percent under the Income Test).

respects” could lead to interpretive issues necessitating a definition or examples.<sup>208</sup> Some commenters also expressed concern that accountants may not be able to provide negative assurance to underwriters on the combined pro forma financial information where historical financial statements included in the pro forma financial information for individually insignificant acquisitions have not been reviewed or audited.<sup>209</sup> In contrast, one commenter suggested that the procedures required for auditors to provide negative assurance to underwriters on comfort letters are fairly limited and that the proposed changes should not materially impact the auditor’s ability in this regard.<sup>210</sup>

### **c. Final Amendments**

We are adopting the amendments substantially as proposed, but with some modifications after consideration of the comments received. The amendments to Rule 3-05 are intended to reduce the burdens of preparing disclosure about immaterial acquisitions and negotiating with sellers to timely provide historical financial statements, while the new requirement to provide pro forma financial information that shows the aggregate effect of the acquired businesses in all material respects should make it easier for investors to understand the overall effect of those acquisitions on the registrant. Under current rules, registrants often provided separate, audited historical financial statements for acquired businesses that were individually not material to the registrant, and pro forma financial information that did not fully depict the aggregate effect of the “individually insignificant businesses” because currently Article 11 only requires pro forma

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<sup>208</sup> See letters from GT and RSM.

<sup>209</sup> See letters from BDO, CAQ, Cravath, Crowe, DT, GT, and RSM. Some commenters noted that PCAOB AS 6101 would prohibit accountants from providing negative assurance on combined pro forma financial information for which historical financial statements have not been audited or reviewed. See letters from BDO, CAQ, Crowe, GT, and RSM.

<sup>210</sup> See letter from CFA.

financial information for an acquisition for which Rule 3-05 Financial Statements are required.<sup>211</sup> The proposed amendments should address these anomalies, to the benefit of both registrants and investors.

Similar to existing requirements, and as proposed, amended Rule 3-05(b)(2)(iv) will 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 percent for any condition.<sup>212</sup> In this way, the amendments clarify that “individually insignificant businesses” include: (a) Any acquisition consummated after the registrant’s audited balance sheet date whose significance does not exceed 20 percent; (b) Any probable acquisition whose significance does not exceed 50 percent; and (c) Any consummated acquisition whose significance exceeds 20 percent, but does not exceed 50 percent, for which financial statements are not yet required by Rule 3-05(b)(4) because of the 75-day filing period.<sup>213</sup>

As proposed, the amended rule will require registrants to provide pre-acquisition historical financial statements only for those businesses whose individual significance exceeds 20 percent.<sup>214</sup> In conjunction with this change, the amended rule, also as proposed, will require

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<sup>211</sup> For example, if the aggregate of 16 individually insignificant acquisitions is 80 percent significant, with each at five percent, a registrant would 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 percent of the registrant’s pre-acquisition assets or income.

<sup>212</sup> For clarity, we specifically describe the affected businesses in the final rule without reference to the term “individually insignificant businesses.” We also inserted “for any condition” to clarify that the aggregation is done separately for each condition (*e.g.* the investment, asset and income test); that is, the conditions are not combined when assessing whether the “exceeds 50 percent” threshold is met.

<sup>213</sup> This amendment is consistent with existing practice. *See* FRM *supra* note 94 at Section 2035.2.

<sup>214</sup> Registrants will 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 percent, but historical financial statements only for acquisitions that will be required to be reported on Form 8-K (*i.e.*, individual significance

registrants to provide pro forma financial information depicting the aggregate effects of all “individually insignificant businesses” in all material respects.<sup>215</sup> Further, we are revising 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 amended Rules 3-05(b)(2)(iv) or 3-14(b)(2)(i)(C). While several commenters suggested that this requirement could raise interpretive issues, we believe the concept of materiality is well established in our rules, and we are not persuaded at this time that additional guidance is necessary in order for registrants to make this determination.

After considering comments received, we are modifying the proposed rule to require registrants to include both Rule 3-05 businesses and Rule 3-14 real estate operations when determining the aggregate impact of the Investment Test for individually insignificant acquisitions. We are persuaded that such a modification is consistent with our objective of aligning Rule 3-14 with Rule 3-05 because unique industry considerations do not warrant differentiating Rule 3-05 businesses and Rule 3-14 real estate operations, particularly as the modification will apply only to registrants that acquire both Rule 3-05 businesses and Rule 3-14 real estate operations. The final amendments limit this modification to the Investment Test because the Asset Test and Income Test do not apply to Rule 3-14 real estate operations.

Consistent with the existing requirement,<sup>216</sup> we have modified the proposed amendments to Rule 3-05 to indicate that, in determining whether the Income Test condition (*i.e.* both the

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exceeds 20 percent). The amendments could accelerate reporting of historical financial statements for these acquisitions (*i.e.*, individual significance exceeds 20 percent) in certain registration statements and proxy statements if the combined acquisitions exceed 50 percent significance.

<sup>215</sup> See amended Rule 3-05(b)(2)(iv) and revisions to Rule 11-01(c).

<sup>216</sup> See Computational Note 1 to Rule 1-02(w). See also FRM *supra* note 94 at Section 2035.5.

revenue component and the net income component) exceeds 50 percent, the businesses specified in Rule 3-05(b)(2)(iv) reporting losses must be aggregated separately from those reporting income. We also have modified the rule to clarify that if either group exceeds 50 percent, the disclosure requirements apply to all of the businesses subject to the aggregate test and must not be limited to either the businesses with losses or those with income.

We acknowledge that, consistent with existing requirements, the amended aggregate test applies to businesses acquired or to be acquired subsequent to the most recently completed fiscal year. Because some of those acquisitions may have already occurred upon the effective date of the amended rules, we are persuaded that the concern expressed by some commenters about the availability of information to comply with the amended aggregate test necessitates transition guidance.<sup>217</sup>

Separately, we acknowledge concerns expressed as to whether accountants will be able to provide negative assurance to underwriters on the combined pro forma financial information where historical financial statements included in the pro forma financial information for individually insignificant acquisitions have not been reviewed or audited. We recognize that, in some circumstances, accountants may need to perform additional work to be able to provide negative assurance. We also observe that the “reasonable investigation” and “reasonable care” provisions of Sections 11 and 12 of the Securities Act are also fact specific and depend on a variety of factors. Whether steps taken to provide the required disclosures satisfy “reasonable investigation” or “reasonable care,” or whether additional work is needed to provide negative assurance, should be determined by accountants and their clients based on facts and circumstances. Although accountants and their clients may need to take additional steps in

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<sup>217</sup> See Section II.F.

certain circumstances, we believe those concerns are outweighed by the need to improve the usefulness of information provided to investors when the aggregate impact of the specified acquired or to be acquired businesses exceed 50 percent, rather than requiring audited financial statements that are not necessary to reasonably inform investors or pro forma financial information that is materially incomplete in its depiction of the aggregate impact.

**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 for real estate operations warrant differentiated disclosure. If a registrant has acquired or, in certain circumstances, proposes to acquire one or more properties which in the aggregate are significant, Rule 3-14 requires the registrant to file only abbreviated income statements. If the real estate operation is not acquired from a related party, audited Rule 3-14 Financial Statements are required for only one year. In those circumstances where a registrant is permitted to provide one year of financial statements, Rule 3-14 also requires a registrant to describe with specificity the material factors it considered in assessing the real estate operation.<sup>218</sup>

The Commission proposed to further align Rule 3-14 with Rule 3-05 where no unique industry considerations exist because the rules have similar objectives. The Commission also proposed to clarify the application of Rule 3-14 regarding scope of the requirements,<sup>219</sup>

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<sup>218</sup> See Rules 3-14(a)(1)(ii) and 3-14(a)(1)(iii). The material factors include 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. If the registrant does not meet the Rule 3-14(a)(1) conditions, three years of Rule 3-14 Financial Statements are required.

<sup>219</sup> 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. Under existing practice, registrants often provide audited financial statements of the lessee or guarantor of the lease, instead of the Rule 3-14

determination of significance, need for interim income statements, and special provisions for blind pool offerings.<sup>220</sup>

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

Under the current rules, Rule 3-14 and Rule 3-05 diverge in a number of areas. 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 percent significance threshold in the definition of “significant subsidiary” in Rule 1-02(w) when determining “significance” under Rule 3-14.<sup>221</sup> Additionally, Rule 3-14 Financial Statements are currently required when the registrant has acquired or proposes to acquire a group of properties that are significant in the aggregate. In practice, consummated and probable acquisitions since the date of the most recent audited balance sheet that are less than 10 percent significant are aggregated and, if the significance of the aggregated group exceeds 10 percent, Rule 3-14 Financial Statements are provided for each acquisition that is five percent or more significant and for enough other acquisitions in order to cover the substantial majority of the group.<sup>222</sup> Additionally, Rule 3-14 requires registrants to provide three years of financial statements for significant acquisitions from related parties.

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Financial Statements of the real estate operation, when the lessee is considered significant. The proposal did not, and these amendments do not, differentiate this type of acquisition or specify alternatives to Rule 3-14 for this type of acquisition, 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. No commenters that commented on this topic recommended that the Commission require audited financial statements of the lessee or guarantor. See letters from EY, BDO, and GT.

<sup>220</sup> See Section II.C.6 below.

<sup>221</sup> See FRM *supra* note 94 at Section 2310.1 “*Registration Statements and Proxy Statements - Requirements.*”

<sup>222</sup> See FRM *supra* note 94 at Section 2320.

### **a. Proposed Amendments**

The Commission proposed amendments to align Rule 3-14 with Rule 3-05 where no unique industry considerations warranted differentiated treatment. Specifically, the proposed amendments would have, among other things:

- Aligned thresholds in Rule 3-14 with the 20 percent significance threshold and 50 percent aggregate impact significance threshold in Rule 3-05;
- Eliminated the Rule 3-14 requirement to provide three years of Rule 3-14 Financial Statements for acquisitions from related parties;
- Applied Rule 3-06 to Rule 3-14 acquisitions;
- Included the same timing requirements for Rule 3-14 Financial Statements in registration statements and proxy statements as Rule 3-05; and
- Permitted Rule 3-14 Financial Statements to be omitted once the acquired real estate operation had been reflected in filed post-acquisition registrant financial statements for a complete fiscal year.

The Commission additionally proposed to align Rule 3-14 with the relevant proposed Rule 3-05 amendments discussed in Sections II.A. and II.B. above.

### **b. Comments**

Commenters that specifically addressed Rule 3-14 generally supported the proposals.<sup>223</sup> However, some commenters noted that proposed Rule 3-14(c)(2)(iii) would require that the notes to the Rule 3-14 Financial Statements include information about the real estate operation's operating, investing and financing cash flows, to the extent available, and questioned whether such historical information would be comparable to proposed future operations and why such

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<sup>223</sup> See, e.g., letters from Barnard, Cravath, BDO, CAQ, Deloitte, EY, GT, KPMG, NAREIT, and RSM.

disclosure should be required since Rule 3-14 Financial Statements include only statements of revenues and expenses that may omit expenses not comparable to proposed future operations.<sup>224</sup>

**c. Final Amendments**

We are adopting the amendments as proposed. As discussed in the Proposing Release, we believe that further 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.<sup>225</sup>

Specifically, we are adopting amendments as proposed regarding:

*Significance Thresholds.* We are aligning the Rule 3-14 significance threshold for individual acquisitions to the 20 percent threshold for acquired businesses in Rule 3-05.<sup>226</sup> We are also aligning the Rule 3-14 significance threshold for the aggregate impact of acquisitions to the 50 percent threshold in Rule 3-05. Aligning Rule 3-14 with Rule 3-05 will 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.

*Years of Required Financial Statements for Acquisitions from Related Parties.*<sup>227</sup> We are aligning Rule 3-14 with Rule 3-05 by eliminating the specific requirement to provide three years

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<sup>224</sup> See letters from BDO, CAQ, and RSM.

<sup>225</sup> See Section II.C.1 of the Proposing Release.

<sup>226</sup> The Commission raised the threshold in Rule 3-05 from 10 percent to 20 percent 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 and to undertake private or offshore offerings. See 1996 Streamlining Release *supra* note 24. As a result of this amendment, the significance thresholds in Rule 3-05 have diverged from those used for Rule 3-14 since that time.

<sup>227</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

of financial statements for acquisitions from related parties. Rule 3-05 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, and we are not aware of any unique industry considerations that warrant different requirements for Rule 3-14.

*Application of Rule 3-06.* We are aligning 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. Existing Rule 3-06(b) provides that financial statements required under Rule 3-05 “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,” but it did not address acquired real estate operations under Rule 3-14.

*Timing of filings.* We are amending 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>228</sup>

*Omission of Rule 3-14 Financial Statements for Real Estate Operations That Have Been Included in the Registrant’s Financial Statements.* We are aligning the application of Rule 3-14 with the amendments to Rule 3-05 by no longer requiring Rule 3-14 Financial Statements in

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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. These amendments will not affect those requirements.

<sup>228</sup> See *supra* note 15 and accompanying text discussing the Rule 3-05 filing period.

registration statements and proxy statements once the acquired real estate operation is reflected in filed post-acquisition registrant financial statements for nine months.<sup>229</sup>

*Additional Amendments.* We are making additional amendments, as proposed, 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. Many of these amendments will not affect how registrants currently comply with Rule 3-14 because existing practice already analogizes to Rule 3-05 for guidance. Specifically, we are clarifying that:

- “To be acquired” real estate operations must be evaluated under the rule only if they are probable of acquisition;<sup>230</sup>
- The acquisition of an interest in a real estate operation accounted for using the equity method<sup>231</sup> or, in lieu of the equity method, the fair value option, is considered the acquisition of a real estate operation;
- Rule 3-14 does not apply to a real estate operation that is totally held by the registrant prior to consummation of the transaction;<sup>232</sup>
- If registering an offering of securities to the security holders of the real estate operation to be acquired, the financial statements for the acquired real estate operation must cover the

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<sup>229</sup> See discussion of the omission of Rule 3-05 Financial Statements in Section III.1B.3. above. The provision in Rule 3-05 regarding omission of financial statements for acquisitions exceeding 40 percent significance is inapplicable in Rule 3-14.

<sup>230</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 amendment codifies the current practice of interpreting this phrase to mean “probable of acquisition.” See FRM *supra* note 94 at Section 2310.1

<sup>231</sup> See FRM *supra* note 94 at Section 2305.4.

<sup>232</sup> See Rule 3-05(a)(4), as amended. See also Rule 1-02(y) for the definition of the term “totally held subsidiary.”

periods specified in Rules 3-01 and 3-02, except as provided otherwise for filings on Forms N-14, S-4 or F-4, and that the financial statements covering those fiscal years must be audited except as provided in Item 14 of Schedule 14A with respect to certain proxy statements or in registration statements filed on Forms N-14, S-4, or F-4,<sup>233</sup>

- Related real estate operations must be treated as a single acquisition for significance testing;<sup>234</sup> and
- Pro forma amounts are permitted for significance testing in certain circumstances consistent with the application in Rule 3-05.<sup>235</sup>

The amendments also 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>236</sup> In addition, the amendments conform the requirements related to acquisitions of foreign real estate operations in Rule 3-14 to the analogous provisions in Rule 3-05.<sup>237</sup>

Aside from the substance of the rules, the amendments also conform the organization and format of certain related rules and forms, as appropriate. We are amending Item 8 of Form 10-K which currently exempts registrants from complying with Rule 3-05 and Article 11, to include

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<sup>233</sup> See Rule 3-05(b)(1), as amended.

<sup>234</sup> See Rules 3-05(a)(3) and 3-14(a)(3), as amended. 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>235</sup> See Rules 3-05(b)(3) and 11-01(b)(3), as amended.

<sup>236</sup> See Rules 3-05(a)(1), 3-05(b)(2), 3-14(a)(1), and 3-14(b)(2), as amended.

<sup>237</sup> See Rules 3-05(c) and 3-14(d), as amended, and Rules 3-05(d) and 3-14(e).

Rule 3-14,<sup>238</sup> instead of retaining the exception in Rule 3-14 itself. We are also conforming the general format and wording of Rule 3-14 to Rule 3-05, as appropriate, for consistency and to make the rule easier to follow.<sup>239</sup>

Finally, we are also revising Form 8-K to:

- 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>240</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.

Also, as proposed, we are adopting amendments to conform Rule 3-14 to the Rule 3-05 amendments being adopted in this release where no unique industry considerations exist.

Specifically, we are amending Rule 3-14 to conform to the amendments described in Section II.A.1.c (Investment Test only), Section II.A.3.c (related only to certain required footnote

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<sup>238</sup> See Item 8(a) of Form 10-K.

<sup>239</sup> The changes in Rule 3-14 to conform wording include the addition of a paragraph similar to amended Rule 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. We are also eliminating the Instruction in Item 9 of Form S-11, which refers back to the guidance in paragraphs (a)(2) and (a)(3) of Rule 3-14.

<sup>240</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, in practice 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 94 at Section 2310.3.

disclosures),<sup>241</sup> Section II.A.5.c, Section II.A.6.c, Section II.B.1.c (excluding the requirement related to acquisitions that exceed 40 percent significance, which does not apply to Rule 3-14), Section II.B.2.c and Section II.B.3.c.

## 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 these terms.<sup>242</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>243</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.<sup>244</sup> The Commission staff has additionally provided guidance that a real estate operation includes real properties that will

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<sup>241</sup> The footnote disclosure to provide an explanation of the impracticability of preparing financial statements that include the omitted expenses is not applicable to Rule 3-14 Financial Statements because Rule 3-14 does not contain an impracticability condition. *See* Note 12. With respect to the footnote disclosure related to historical cash flows, we acknowledge, as observed by some commenters, that certain historical cash flows of a real estate operation may not be comparable to proposed future operations. However, we believe that there is also cash flow information that would be meaningful to investors if available, for example, disclosure regarding historical cash flows for capital improvements. We are, therefore, adopting this requirement as proposed.

<sup>242</sup> *See* FRM *supra* note 94 at Section 2305.1 “*Applicability of S-X 3-14*,” and Section 2305.2, “*Nature of Real Estate Operations*.”

<sup>243</sup> *See* FRM *supra* note 94 at Section 2305.2.

<sup>244</sup> 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 market and managerial factors.

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>245</sup>

**a. Proposed Amendments**

The Commission proposed 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 and staff interpretations<sup>246</sup> and to remove the unnecessary condition in Rule 11-01(a)(5) that clarifies that Article 11 applies to real estate operations.

**b. Comments**

We received limited comment specific to the proposed definition of real estate operations. Two commenters explicitly supported the definition, and no commenters opposed it.<sup>247</sup> One of these commenters recommended adding “or substantially all the assets of which are held for lease” in order to include real property that is not currently leased, but is being acquired with the intention of leasing and has more than a nominal leasing history.<sup>248</sup> This commenter further recommended amending Rule 11-01(d) to clarify that there is a presumption that real property that is leased or held for lease to third parties constitutes a business. In addition, the same commenter recommended that we consider explicitly addressing real properties that have a

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<sup>245</sup> See FRM *supra* note 94 at Section 2305.3 “*Investment in a Pre-Existing Legal Entity.*”

<sup>246</sup> The proposed amendment used 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 through an entity holding real property under lease or of a direct interest in the real property. See proposed Rule 3-14(a)(2).

<sup>247</sup> See letter from Cravath and NAREIT.

<sup>248</sup> See letter from NAREIT.

limited leasing history or leasing history that is unrepresentative of expected future operations.<sup>249</sup> Another commenter recommended the Commission further clarify the meaning of “substantially all.”<sup>250</sup>

### **c. Final Amendments**

We are amending Rule 3-14 to define a real estate operation as proposed as “a business that generates substantially all of its revenues through the leasing of real property.” We considered clarifying what is meant by “substantially all” in this context, as one commenter suggested. However, this term is not meant to be a bright line, and its application will depend on specific facts and circumstances. Accordingly, we are not making any changes in this regard.

We also considered whether additional language is necessary to address an acquisition of real property that is not leased and generating revenues upon acquisition, but was historically leased and is intended to be leased again in the near future. However, we do not believe that the definition, as proposed, requires any changes, because in these circumstances a registrant should consider whether the lack of revenues at acquisition may be unrepresentative based on the existence of a leasing history and the expected continuation of the leasing operation, and thus could still conclude that it is a business that generates substantially all of its revenues through the leasing of real property. We also considered whether we should add language to address acquisitions of real property with a limited leasing history or a leasing history that is unrepresentative of expected future operations. However, we believe those situations are best addressed through Rule 3-13.<sup>251</sup>

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<sup>249</sup> See letter from NAREIT. See also FRM *supra* note 94 at Section 2330.8 “*Rental History of Less Than Nine Months*,” Section 2330.9, “*Exception for Demolition*” and Section 2330.10 “*Exception for Properties with No or Nominal Leasing History*” for related staff guidance.

<sup>250</sup> See letter from GT.

<sup>251</sup> See Rule 3-13 *supra* note 58.

We believe the definition we are adopting appropriately frames the application of Rule 3-14, reduces uncertainty regarding the meaning of the term, and serves to clarify the rule without changing the substance of how it is currently applied. In light of the adopted definition that clarifies that a real estate operation is a “business” as that term is used in Article 11, we are removing the condition in Rule 11-01(a)(5) as it is no longer necessary.<sup>252</sup>

### 3. Significance Tests

As noted above, Rule 3-14 does not provide explicit guidance on how to determine whether a real estate operation is significant. 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 and its other subsidiaries’ “investments in”<sup>253</sup> 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 when determining “significance” under Rule 3-14.<sup>254</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>255</sup>

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<sup>252</sup> We considered whether Rule 11-01(d) should include a presumption that real property that is leased or held for lease is a business, but we believe it is more appropriate for registrants to evaluate for each acquisition the facts and circumstances included in the rule to determine if it constitutes a business.

<sup>253</sup> See *supra* note 53.

<sup>254</sup> See FRM *supra* note 94 at Section 2315 “*Real Estate Operations - Measuring Significance.*”

<sup>255</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.

**a. Proposed Amendments**

The Commission proposed to amend Rule 3-14 to specify that significance should be based on the Investment Test in Rule 1-02(w). Thus, consistent with the proposed amendments for Rule 3-05 acquisitions discussed above, the Commission proposed to require comparison with the registrant's aggregate worldwide market value. If aggregate worldwide market value is not available, then the Investment Test would be based on total assets. When the test is based on total assets for real estate acquisitions, the Commission also proposed to modify the investment amount to include any debt secured by the real properties that is assumed by the registrant.

**b. Comments**

We received limited comment addressing the significance tests as they relate to real estate operations.<sup>256</sup> One commenter recommended allowing registrants that do not have an aggregate worldwide market value (such as non-traded REITs) to use net asset value of their common equity as the denominator for the Investment Test.<sup>257</sup>

**c. Final Amendments**

We are amending Rule 3-14(b)(2) as proposed to require use of the Investment Test in Rule 1-02(w).<sup>258</sup> We believe this amendment will reduce uncertainty regarding the significance tests and clarify the rule without changing the substance of how it is currently applied. When based on total assets, the final amendments specify, as proposed, that the test should be adapted

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<sup>256</sup> See e.g., letter from EY.

<sup>257</sup> See letter from EY. This commenter further recommended that, if such a registrant is not permitted to use net asset value, the numerator should be limited to the consideration transferred and exclude any debt assumed by the buyer.

<sup>258</sup> We are not adopting amendments to permit non-traded REITs to use net asset value instead of aggregate worldwide market value due to the potential application complexities; however, we are adopting the modified investment test addressed in Section II.C.6., below, for blind pool offerings that will be applicable to non-traded REITs.

to compare the registrant's and its other subsidiaries' "investments in"<sup>259</sup> the real estate operation, including any debt secured by the real properties that is assumed by the registrant, to the registrant's total assets as of the end of the most recently completed fiscal year. We believe a modified Investment Test is necessary to appropriately determine significance for acquisitions of real estate operations because it takes into consideration 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.

#### 4. Interim Financial Statements

Unlike Rule 3-05,<sup>260</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>261</sup> Article 11 further provides that the pro forma condensed statement of comprehensive income must 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>262</sup> As a result of Article 11 and related staff interpretations, existing registrant practice is to provide interim financial statements for acquisitions of real estate operations.<sup>263</sup>

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<sup>259</sup> See *supra* note 53.

<sup>260</sup> See Rule 3-05(b)(2)(i) through (iv). The rule refers explicitly to the most recent fiscal year and any interim periods specified in Rules 3-01 and 3-02.

<sup>261</sup> See Rule 11-01.

<sup>262</sup> See Rule 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>263</sup> See Rule 11-02(c)(2)(i) and FRM *supra* note 94 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."

**a. Proposed Amendments**

The Commission proposed 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.

**b. Comments and Final Amendments**

We received no comments specifically related to this proposal, so we are adopting the amendment to Rule 3-14(b)(2)(i) as proposed.<sup>264</sup>

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

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 issuer relying on Regulation A to present financial statements of real estate operations acquired or to be acquired as specified by Rule 8-06.<sup>265</sup>

**a. Proposed Amendments**

The Commission proposed amendments to Article 8 to further simplify and conform the application of Rule 3-14 and our related proposals to smaller reporting companies.

**b. Comments**

None of the commenters that provided comments related to smaller reporting companies and smaller issuers commented on the proposed amendments to Rule 3-14.

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<sup>264</sup> See Section II.C.4 of the Proposing Release.

<sup>265</sup> See paragraph (b)(7)(v) of Part F/S. Part F/S of Form 1-A permits the periods presented to be the shorter of those applicable to issuers relying on Regulation A and the periods specified by Article 8.

### c. Final Amendments

We are amending Rule 8-06 as proposed to direct registrants to Rule 3-14 for the requirements relating to financial statement disclosures of real estate operations acquired or to be acquired,<sup>266</sup> while still permitting smaller reporting companies to rely on the form and content for annual and interim financial statements provided in Rules 8-02 and 8-03. Rule 8-06 as amended will newly require smaller reporting companies to combine the discussion of material factors that they considered in assessing the acquisition with the disclosure required by Item 15 of Form S-11 when financial statements are presented in Form S-11.<sup>267</sup> We are also adding a reference to Rule 8-06 in Rule 3-06 to conform the requirements of Rule 8-06 and Rule 3-14 and adding Rule 8-01(f) 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.<sup>268</sup>

Additionally, because Part F/S of Form 1-A refers to Rule 8-06, the revisions to Rule 8-06 apply to issuers relying on Regulation A. As discussed in the Proposing Release, we believe these amendments will simplify these rules and reduce burdens for smaller reporting companies and issuers relying on Regulation A.<sup>269</sup>

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<sup>266</sup> We are also amending the instruction in Item 9.01 of Form 8-K to include references to Rule 8-06 in order to conform the instruction to the text of Item 9.01, which already addresses the rules applicable to smaller reporting companies.

<sup>267</sup> See Instruction to Paragraph (f) in Rule 3-14. Since Item 15 of Form S-11 already applies to smaller reporting companies, the Instruction changes only the location of the discussion.

<sup>268</sup> See Rule 8-01(f) and the discussion related to Rule 3-06 in Section II.C.1 above.

<sup>269</sup> See Section II.C.5 of the Proposing Release.

## 6. Blind Pool Real Estate Offerings

Certain registrants, typically non-traded real estate investment trusts (“REITs”),<sup>270</sup> that conduct continuous offerings over an extended period of time follow the disclosure guidance provided under Industry Guide 5 *Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships* (“Industry Guide 5”).<sup>271</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>272</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, these registrants typically apply adapted significance tests when making the determination of whether they are required to provide Rule 3-14 Financial Statements.<sup>273</sup>

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<sup>270</sup> Non-traded REITs do not have securities listed for trading on a national securities exchange. Their purpose is to own and operate income-producing real estate or real estate-related assets.

<sup>271</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)]. 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>272</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 94 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.

<sup>273</sup> 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.

Commission staff has interpreted significance during the distribution period to be computed by comparing the registrant's and its other subsidiaries' "investments in"<sup>274</sup> 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>275</sup> After the distribution period has ended, the registrant determines 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>276</sup>

**a. Proposed Amendments**

The Commission proposed amendments to codify existing staff guidance by specifying that significance for blind pool offerings must be computed by comparing the registrant's and its other subsidiaries' "investments 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.

**b. Comments**

Commenters generally supported the proposed amendments.<sup>277</sup> These commenters, however, recommended that, for registrants conducting blind pool offerings, the Commission

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<sup>274</sup> See *supra* note 53.

<sup>275</sup> See FRM *supra* note 94 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>276</sup> See FRM *supra* note 94 at Section 2325.5 "Blind Pool Offerings – After the Distribution Period."

<sup>277</sup> See letters from BDO, CAQ, DT, EY, GT, NAREIT, PWC, and RSM.

extend the accommodations to acquisitions within the scope of Rule 3-05.<sup>278</sup> In support of this change, one commenter noted that staff guidance and Guide 5 do not distinguish between acquisitions of real estate and other operations with regards to the expected reporting of undertakings.<sup>279</sup>

### **c. Final Amendments**

We are adopting the amendments as proposed, but with modifications after considering comments received. We are codifying staff interpretations in this area to provide that significance for blind pool offerings must be computed by comparing the registrant's and its other subsidiaries' "investments 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 as more fully described above. Without this accommodation, virtually all acquisitions in the early part of the distribution period would be deemed significant regardless of their size.

We are also adopting amendments, as suggested by commenters, to extend the adapted significance test to Rule 3-05 acquisitions by registrants in blind pool offerings because the accommodation is based on the unique characteristics of the offering and registrants, rather than the type of acquisition.

In light of the extension of the accommodation to Rule 3-05 acquisitions, we revised the location of these amendments for blind pool offerings to Rule 11-01(b), which addresses how to determine significance for both Rule 3-05 acquisitions and Rule 3-14 acquisitions.<sup>280</sup>

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

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<sup>278</sup> *See id.*

<sup>279</sup> *See* letter from NAREIT.

<sup>280</sup> *See* Rule 11-01(b)(4). Rules 3-05 and 3-14 were also revised to refer to new Rule 11-01(b)(4).

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 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 percent and 10 percent significance thresholds under Rule 3-05 and Rule 3-14, respectively.<sup>281</sup> The rules also require pro forma financial information for a significant disposed business at a 10 percent 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>282</sup> The rules call for pro forma financial information to show the impact of the transaction on income from continuing operations of the registrant.<sup>283</sup>

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<sup>281</sup> See 1996 Streamlining Release *supra* note 24.

<sup>282</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>283</sup> Discontinued operations would not be reflected in the condensed historical financial statements used as the starting point for the pro forma presentation.

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
- Factually supportable.<sup>284</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.

#### **a. Proposed Amendments**

The Commission proposed to revise Article 11 by replacing the existing pro forma adjustment criteria with simplified requirements to depict the accounting for the transaction (“Transaction Accounting Adjustments”)<sup>285</sup> and present the reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur (Management’s

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<sup>284</sup> See Rule 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>285</sup> Under the proposed rule, 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, 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. 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. Under the proposed rule, 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).

Adjustments”).<sup>286</sup> In addition, the Commission proposed other changes to simplify and clarify Article 11 and to provide more consistent use of terminology. The Commission proposed these changes because the existing pro forma adjustment criteria are not clearly defined, can yield inconsistent presentations for similar fact patterns, and preclude the inclusion of adjustments for the potential effects of post-acquisition actions expected to be taken by management.

## **b. Comments**

While commenters were generally supportive of replacing the existing pro forma adjustment criteria with the proposed Transaction Accounting Adjustments,<sup>287</sup> one commenter

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<sup>286</sup> Under the proposed rule, 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. However, if the registrant previously was a part of another entity and presentation of pro forma financial information was necessary to reflect the 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. For example, where a company (the registrant) operates as a subsidiary of another entity and files a registration statement under the Securities Act 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. The proposed rule also included presentation requirements for Management’s Adjustments, requiring that they be presented through a separate column in the pro forma financial information after the presentation of the combined historical statements and Transaction Accounting Adjustments. 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, the proposed rules would require 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. Further, the proposed rule would include specific disclosures for each Management’s Adjustments including: 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. For synergies and other transaction effects that are not reasonably estimable and will not be included in Management’s Adjustments, the proposed rule would require that qualitative information necessary for a fair and balanced presentation of the pro forma financial information also be provided.

<sup>287</sup> See letters from Ball, Davis Polk, DT, FEI, New York City Bar Association, Committee on Mergers and Acquisitions (“NYCBA-M&A”), Pfizer, and SIFMA. One of these commenters noted that under the existing rules, pro forma financial statements can be difficult for registrants to prepare and are among the most prolific sources of questions for the staff. See letter from NYCBA-M&A.

recommended retaining the existing methodology.<sup>288</sup> Several commenters recommended changes or sought clarification regarding the application of the rules to Transaction Accounting Adjustments.<sup>289</sup> However, most of the comments received relating to pro forma financial information were focused on Management’s Adjustments. Commenters were mixed in their support<sup>290</sup> or opposition<sup>291</sup> to the proposed Management’s Adjustments depicting synergies and other transaction effects.

Many commenters recommended against including the proposed Management’s Adjustments in pro forma financial statement requirements.<sup>292</sup> Some of these commenters suggested that pro forma financial information is an inapt means for communicating the anticipated synergies from a transaction.<sup>293</sup> These commenters also expressed concerns relating to: the inherent uncertainty/subjectivity of synergy expectations; the burden of preparing the disclosure; the potential liability; the risk of synergy disclosure changing over time and

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<sup>288</sup> See letter from Cravath. Cravath indicated that it does not believe that there is significant confusion among preparers of financial information or investors with respect to the current Article 11 pro forma adjustment methodology, including using the current “continuing impact” criterion, or the benefits and limitations of such disclosure. However, Cravath also indicated that it had significant concerns regarding the proposal to require Management’s Adjustments and opposed the inclusion of such a requirement in the final rules. Accordingly, Cravath recommended retaining the existing methodology.

<sup>289</sup> See, e.g., letters from BDO, Davis Polk, DT, and FEI. For example, one of these commenters recommended the final rule permit the inclusion of pro forma adjustments for additional events that are directly related to the transaction, (e.g. adjusting for the effects of additional financing necessary to complete the acquisition). See letter from FEI. Another commenter recommended continuing to exclude nonrecurring items from the pro forma statement of comprehensive income and providing clarity about how to define non-recurring items. See letter from Davis Polk.

<sup>290</sup> See, e.g., letters from Allstate, Ball, CFA, Davis Polk, IMA, MTBC, and PWC.

<sup>291</sup> See, e.g., letters from Cravath, Eli Lilly, FEI, GT, Nasdaq, NYCBA-M&A, Pfizer, SIFMA, Shearman, and Williams. See also SBCFAC Recommendations, recommending that “the proposed amendments to the pro forma financial information requirements with respect to whether the proposed addition of Management’s Adjustments, which are intended to reflect reasonably estimable synergies and transaction effects, should be optional or not required at all.”

<sup>292</sup> See, e.g., letters from Eli Lilly, Liberty, NYCBA-M&A, NYCBA – Sec., Pfizer, S&C, and SIFMA. See also SBCFAC Recommendations.

<sup>293</sup> See, e.g., letters from S&C and NYCBA-M&A.

confusing or misleading investors; and other unintended consequences.<sup>294</sup> In contrast, commenters supportive of the requirement indicated that the proposed Management’s Adjustments would provide investors insight into the potential effects of the acquisition and post-acquisition plans expected to be taken by management<sup>295</sup> and provide greater flexibility for management to include forward-looking information and provide investors with insight into their decision to enter into the transaction.<sup>296</sup>

Many commenters, whether supportive of or opposed to the proposed requirements, recommended that the Commission provide additional guidance or clarification about their application, particularly with respect to the proposed Management’s Adjustments.<sup>297</sup> Commenters recommended that the Commission provide examples of synergies and other transaction effects and the treatment of nonrecurring costs to achieve them.<sup>298</sup> Commenters also requested other implementation guidance, such as guidance on: the criteria for determining “reasonably estimable” and the permissible range; the timing parameters relating to realization and “reasonably expected” to occur; what would constitute a “fair and balanced presentation”; the relationship between Management’s Adjustments on the pro forma statements of

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<sup>294</sup> *See, e.g.*, letters from Cravath, Debevoise, Eli Lilly, FEI, GT, KPMG, Liberty, Nasdaq, NYCBA-M&A, Pfizer, S&C, SIFMA, Shearman, and Williams. Some of these commenters further suggested the reasonably expected synergy disclosure requirement could, among other things, result in premature disclosure of sensitive information that could affect important relationships with stakeholders, impact boards of directors, auditors, and underwriters, and have a chilling effect on disclosure. *See, e.g.*, letters from FEI and Pfizer.

<sup>295</sup> *See, e.g.*, letters from Ball, CFA, IMA, and PWC. One of these commenters supported inclusion of the disclosure because, in the commenter’s view, the information provided to investors in connection with marketing the deal should be consistent with, if not reconciled to, management projections provided to the board and shareholders, or the projections provided to financial advisors in connection with the fairness opinion. *See* letter from CFA.

<sup>296</sup> *See, e.g.*, letters from Ball and CAQ.

<sup>297</sup> *See, e.g.*, letters from DT, Liberty, Pfizer, and PWC.

<sup>298</sup> *See, e.g.*, letters from BDO, CAQ, Crowe, Davis Polk, DT, EY, GT, KPMG, PWC, and RSM.

comprehensive income and those on the balance sheet; updating requirements for Management’s Adjustments in subsequent filings; the presentation of multiple transactions; and treatment of overlap between Transaction Accounting Adjustments and Management’s Adjustments.<sup>299</sup>

Some commenters that expressed concern relating to liability for the disclosure sought by the proposed amendments supported the application of the forward-looking information safe harbors under Securities Act Rule 175 and Exchange Act Rule 3b-6,<sup>300</sup> while other commenters recommended further protections, such as a safe harbor for forward-looking information similar to that found in the PSLRA safe harbor,<sup>301</sup> permitting Article 11 information to be “furnished” rather than “filed,”<sup>302</sup> or an exception or safe harbor for cases where synergies are not a material element of the transaction.<sup>303</sup>

Several commenters recommended the Commission consider whether such disclosure should be optional.<sup>304</sup> Other commenters recommended other ways to limit the proposed Management’s Adjustments disclosure requirements while still providing useful information.<sup>305</sup>

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<sup>299</sup> *See, e.g.*, letters from BDO, CFA, Crowe, Debevoise, DT, EY, FEI, GT, IMA, KPMG, RSM, and S&C.

<sup>300</sup> *See* letters from Allstate, CFA, Cravath, Debevoise, PWC, and SIFMA. One of these commenters recommended that the final rules expressly provide a safe harbor for forward-looking information and that it include express language that the safe harbors apply to any pro forma financial information that includes both historical and forward-looking information. This commenter also expressed concern that the proposed requirement to provide qualitative information necessary for a fair and balanced presentation of the pro forma financial information when synergies and other transaction effects would not be included in Management’s Adjustments because they are not reasonably estimable represented a new disclosure liability standard. *See* letter from Cravath.

<sup>301</sup> *See* letter from Davis Polk.

<sup>302</sup> *See* letter from S&C.

<sup>303</sup> *See* letter from NYCBA – M&A.

<sup>304</sup> *See, e.g.*, letters from BDO, Cravath, EY, and Williams. One of these commenters suggested that if Management’s Adjustments were optional they could be removed from the pro forma financial information and underwriters could receive customary comfort as part of their due diligence process. *See* letter from BDO. Another commenter recommended the disclosure be optional or not required for smaller reporting companies. *See* SBCFAC Recommendations.

<sup>305</sup> *See, e.g.*, letters from Davis Polk, FEI, and S&C.

For example, two commenters recommended limiting the requirement to narrative disclosure of synergies information in transactions where the information has otherwise been publicly disclosed.<sup>306</sup> Another commenter recommended comprehensive disclosure in the footnotes of the related non-recurring costs and anticipated timing of the run-rate synergies.<sup>307</sup>

### **c. Final Amendments**

We are adopting the amendments with modifications after considering comments received. We are amending Article 11, as proposed, by replacing the existing pro forma adjustment criteria with simplified requirements to depict the accounting for the transaction and to provide the option to depict synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given. We also are adopting, as proposed, other changes to simplify and clarify Article 11 and use terminology more consistently.<sup>308</sup> Additionally, we are, as proposed, deleting existing Rule 11-02(a), which describes the objectives of the preparation requirements, to avoid confusion and focus registrants on the requirements of the rule.

The revised pro forma adjustment criteria we are adopting are broken out into three categories:

- (i) “Transaction Accounting Adjustments;”
- (ii) “Autonomous Entity Adjustments;” and

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<sup>306</sup> See letters from Cravath and S&C.

<sup>307</sup> See letter from Davis Polk.

<sup>308</sup> Specifically, we are amending Article 11, as proposed, to refer to “pro forma financial information,” “potential common stock” as defined in U.S. GAAP, and “pro forma basic” per share data throughout, as well as amending existing 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 because that amount is used to calculate earnings per share under U.S. GAAP. See amended Rule 11-02(a)(5). We are also, as proposed, amending existing Rule 11-01(a)(8) to remove the reference to other “events” as the concept of other events is encompassed by the reference to “other transactions” and amending existing Rule 11-02(b)(2) to refer to “each transaction for which pro forma effect is being given” in recognition that the information may be required to give effect to more than one transaction. See amended Rules 11-01(a)(8) and 11-02(a)(2).

(iii) “Management’s Adjustments.”<sup>309</sup>

The Transaction Accounting Adjustments reflect only the application of required accounting to the acquisition, disposition, or other transaction linking the effects of the acquired business to the registrant’s audited historical financial statements. Autonomous Entity Adjustments are adjustments necessary to reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity. Management’s Adjustments provide both flexibility to registrants to include forward-looking information that depicts the synergies and dis-synergies identified by management in determining to consummate or integrate the transaction for which pro forma effect is being given and insight to investors into the potential effects of the acquisition and the post-acquisition plans expected to be taken by management. Under the final amendments, Transaction Accounting Adjustments and Autonomous Entity Adjustments are required adjustments. Management’s Adjustments, as discussed further below, are optional under the final amendments.

*Transaction Accounting Adjustments and Autonomous Entity Adjustments*

We are adopting the Transaction Accounting Adjustments, as proposed, in amended Rule 11-02(a)(6)(i) to require registrants to depict: (1) In the pro forma condensed balance sheet the

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<sup>309</sup> As proposed, the amendments: (i) 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 is superseded by the requirements for Transaction Accounting Adjustments and Autonomous Entity Adjustments; (ii) Eliminate Instruction 3 regarding business dispositions as it is no longer necessary given the adoption of proposed Rules 11-02(a)(4), 11-02(a)(6), and 11-02(b)(3); (iii) Incorporate the substance of Instruction 1, using income from continuing operations, into amended Rule 11-02(b)(1) and Instruction 2 guidance on financial institutions into amended Rule 11-02(b)(2); (iv) 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 must be presented in separate columns; and (v) Add new Rule 11-02(b)(5) to replace Instruction 7 to Rule 11-02(b), which will codify 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.*

accounting for the transaction required by U.S. GAAP or IFRS-IASB, as applicable,<sup>310</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>311</sup> Consistent with the proposal, the amendment indicates that if the condition in Rule 11-01(a) that is met does not have a balance sheet effect, then the Transaction Accounting Adjustments to the pro forma statement of comprehensive income should depict the accounting for the transaction required by U.S. GAAP or IFRS-IASB, as applicable. Further, in a modification from the proposal made in response to comments, the amendments clarify that pro forma statement of comprehensive income “adjustments must be made whether or not the pro forma balance sheet is presented pursuant to paragraph (c)(1) of this section.”

In order to effect the changes described below to our Management’s Adjustments proposal, the requirement to show the registrant as an autonomous entity if the condition in Rule 11-01(a)(7) is met has been relabeled as “Autonomous Entity Adjustments” and relocated from the subparagraph concerning Management’s Adjustments to Rule 11-02(a)(6)(ii) to clarify that such adjustments are required when the condition for their presentation is met and that they must be presented in a separate column from Transaction Accounting Adjustments.<sup>312</sup>

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<sup>310</sup> Transaction Accounting Adjustments are 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 is as of the most recent practicable date prior to the effective date (for registration statements) or the mailing date (for proxy statements).

<sup>311</sup> See Rule 11-02(a)(6)(i)(B).

<sup>312</sup> We believe this requirement is appropriate given the different purposes for which Transaction Accounting Adjustments and Autonomous Entity Adjustments are used. It will also facilitate compliance with the requirements for determining significance of acquisitions and dispositions using pro forma financial information, which as proposed will only include Transaction Accounting Adjustments. See Rule 11-01(b)(3)(i)(B).

As proposed, the amendments will require that historical and pro forma per share data must be presented on the face of the pro forma condensed statement of comprehensive income and give effect to Transaction Accounting Adjustments. However, in a further modification from the proposal<sup>313</sup> to effect the changes described below to our Management's Adjustment proposal, the amendments require that such pro forma per share data also give effect to Autonomous Entity Adjustments.<sup>314</sup> We believe that including all adjustments required by our amendments to be presented on the face of the pro forma financial information, whether deemed recurring or nonrecurring by a registrant's management, will help achieve consistency in the application of our pro forma requirements and simplify compliance. This requirement, coupled with the requirement to disclose revenues, expenses, gains and losses and related tax effects that will not recur in the income of the registrant beyond 12 months after the transaction, will also enhance transparency.

#### *Management's Adjustments*

We agree with commenters that providing forward-looking information, subject to appropriate safe harbors, about synergies and related-transaction effects contemplated by the board and management in determining to execute the acquisition or disposition of a business would provide useful information for understanding the effects of the transaction. However, having considered the comments received, we are persuaded that the line-item specificity and the one year time horizon presented in our proposed pro forma requirements is not necessarily

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<sup>313</sup> We do not believe it is necessary, as some commenters suggested, to modify our proposal to permit the inclusion of pro forma adjustments for additional events that are directly related to the transaction (*e.g.* adjusting for the effects of additional financing necessary to complete the acquisition) because Rule 11-01(a)(8) requires giving pro forma effect when consummation of other transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors.

<sup>314</sup> We were not persuaded by the suggestion to further modify our proposal to permit exclusion of nonrecurring items from the pro forma statement of comprehensive income or to define non-recurring items.

consistent with the manner in which synergy estimates are made and that not all transactions attach the same level of importance to synergies as a rationale for choosing to pursue the transaction. We are further persuaded that there may be different levels of confidence about different types of synergies and transaction effects and that disclosure requirements should be crafted with appropriate flexibility to permit management to depict full run-rate synergies and the nonrecurring costs to achieve them if, and in a manner, they deem appropriate. For example, we believe cost synergies should be permitted to be presented without revenue synergies provided that they incorporate related dis-synergies and the related disclosure describes the nature, uncertainties, and limitations of the amounts presented and the time-frames and uncertainties inherent in achieving them. We also believe such disclosure should be linked to pro forma financial information as a means to more fully demonstrate how historical amounts could change based on the transaction.

After considering comments received on the proposals, we are modifying the amendments to provide that Management's Adjustments depicting synergies and dis-synergies of the acquisitions and dispositions for which pro forma financial information is being given may, in the registrant's discretion, be presented if in its management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction.<sup>315</sup> We encourage registrants to provide Management's Adjustments in these circumstances when certain additional conditions are met. Because under the final amendments the presentation of Management's Adjustments is optional, we are modifying the proposed rules such that, in order to present Management's Adjustments, certain conditions related to the basis for Management's Adjustments and the form of presentation must be met. These amendments are intended to

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<sup>315</sup> See Rule 11-02(a)(7).

ensure that if Management's Adjustments are presented, they are done so consistently and in a manner that would not be misleading to investors. Specifically, as modified, the *Basis for Management's Adjustments* in Rule 11-02(a)(7)(i) requires as conditions for presenting Management's Adjustments that:

- There is a reasonable basis for each such adjustment;
- The adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented. If such adjustments reduce expenses, the reduction shall not exceed the amount of the related expense historically incurred during the pro forma period presented; and
- The pro forma financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed. When synergies are presented, any related dis-synergies shall also be presented.

Further, as modified, the *Form of Presentation* in Rule 11-02(a)(7)(ii) requires as additional conditions for presenting Management's Adjustments that:

- If presented, Management's Adjustments must be presented in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data to such amounts after giving effect to Management's Adjustments.

- If presented, Management's Adjustments included or incorporated by reference into a registration statement, proxy statement, offering statement or Form 8-K should be as of the most recent practicable date prior to the effective date, mail date, qualified date, or filing date as applicable, which may require that they be updated if previously provided in a Form 8-K that is appropriately incorporated by reference.
- If Management's Adjustments will change the number of shares or potential common shares, the change must be reflected within Management's Adjustments 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.
- The explanatory notes must also include disclosure of the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment.<sup>316</sup>

We believe these requirements are necessary to better enable an investor to understand Management's Adjustments being made in the pro forma financial information and that this presentation will clearly 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 and other uncertainties.

Some commenters cited similarities between pro forma Management's Adjustments and projections. While we believe they are distinct, because Management's Adjustments may include measures that require similar judgments to projections, we have looked to the

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<sup>316</sup> See Rule 11-02(a)(11)(iii).

Commission's policy statement on projections in developing a framework for optional disclosure of Management's Adjustments.<sup>317</sup> Specifically, the amended rules include disclosure requirements related to the Basis for Management's Adjustments and Form of Management's Presentation.<sup>318</sup> Likewise, the final amendments require that there is a reasonable basis for each such adjustment and that the pro forma financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed.<sup>319</sup> The final amendments also require disclosure of both the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment.<sup>320</sup> The amendments also provide practical limits tailored to the pro forma financial information presentation.<sup>321</sup>

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<sup>317</sup> See Item 10(b) of Regulation S-K.

<sup>318</sup> See Rule 11-02(a)(7)(i) and (ii).

<sup>319</sup> See Rule 11-02(a)(7)(i)(A). This requirement is similar to the representation management must disclose in historical interim financial statements subject to Article 10, *Interim financial statements*, (see Rule 10-01(b)(8)) and taken together with the requirement to include dis-synergies if synergies are depicted (see Rule 11-02(a)(7)(i)(C)), we believe it will help achieve much the same purpose as our proposed requirement that pro forma presentations that include Management's Adjustments be fair and balanced. Because we are persuaded that the line-item specificity in our proposed pro forma requirements is not necessarily consistent with the manner in which synergy estimates are made, the amended rules do not include that proposed requirement or the one to disclose for each Management's Adjustment, to the extent known, the reportable segments, products, services, and processes involved; the material resources required, if any, and the anticipated timing.

<sup>320</sup> See Rule 11-02(a)(7)(ii)(C).

<sup>321</sup> For example, the amended rules limit the adjustments to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented. The amended rules further require that if such adjustments reduce expenses, the reduction shall not exceed the amount of the related expense historically incurred during the pro forma period presented. See Rule 11-02(a)(7)(i)(B).

While we encourage registrants to include Management's Adjustments in pro forma financial information, we recognize that such adjustments may not be appropriate for all circumstances. In order to achieve consistency between pro forma financial information presentations that include Management's Adjustments and those that do not, and in recognition that the line item format of pro forma financial information may not be well-suited to Management's Adjustments, the amended rules provide that Management's Adjustments shall be presented in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data to such amounts after giving effect to Management's Adjustments. Because Management's Adjustments might contain forward-looking information, we are amending the rule, as proposed, to include an instruction indicating that any forward-looking information supplied is expressly covered by the safe harbor provisions under 17 CFR 230.175 and 17 CFR 240.3b-6.<sup>322</sup> Given the reference to these safe harbors in the adopted rule and the other modifications we are making with respect to Management's Adjustments, we do not believe there is a need to create new safe harbors or to reference additional safe harbors.

#### *Explanatory Notes*

To further clarify the pro forma financial information disclosure, we are adopting, as proposed, amendments to require disclosure of revenues, expenses, gains and losses, and related tax effects that will not recur in the income of the registrant beyond 12 months after the transaction.<sup>323</sup> Additionally, for Transaction Accounting Adjustments, the final amendments

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<sup>322</sup> See the Instruction to Rule 11-02(a)(6)(ii).

<sup>323</sup> See Rule 11-02(a)(10)(i), based on existing Rule 11-02(b)(5).

will require, as proposed, disclosure of:

- Total consideration transferred or received, including its components and how they were measured. If total consideration includes contingent consideration, the amendments will require disclosure of the contingent consideration arrangement(s),<sup>324</sup> 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
- When the initial 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, 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 regarding the magnitude of any potential adjustments.<sup>325</sup>

In order to effect the changes described above to our Management’s Adjustments proposal, we are relocating the proposed explanatory note disclosures for Management’s Adjustments that we believe also apply to Autonomous Entity Adjustments from the subparagraph concerning Management’s Adjustments to Rule 11-02(a)(11)(iii). Specifically, the amended rules provide that the accompanying explanatory notes shall disclose for each Autonomous Entity Adjustment, a description of the adjustment (including the material uncertainties), the material assumptions, the calculation of the adjustment, and qualitative

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<sup>324</sup> In a modification from the proposal, the amended rule inserts “contingent consideration” before “arrangements” to clarify that the proposed rule’s reference to “arrangement(s)” means “contingent consideration arrangement(s).”

<sup>325</sup> See Rule 11-02(a)(11)(ii).

information about the Autonomous Entity Adjustments necessary to give a fair and balanced presentation of the pro forma financial information.<sup>326</sup> The amendments also tailor the proposed disclosure to reference Autonomous Entity Adjustments and to remove proposed disclosure that related to synergies and other transaction effects rather than to Autonomous Entity Adjustments. Further, the amendments retain for Autonomous Entity Adjustments the proposed requirement to disclose qualitative information about the Autonomous Entity Adjustments necessary to give a fair and balanced presentation of the pro forma financial information.<sup>327</sup>

We are additionally clarifying, as proposed, that: pro forma financial information must be appropriately labeled and presented as required by Article 11,<sup>328</sup> requiring that each transaction for which pro forma effect is required to be given must be presented in a separate column;<sup>329</sup> and requiring that, if pro forma financial information includes another entity's statement of

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<sup>326</sup> The amendments to provide required disclosure for Autonomous Entity Adjustments do not include the following proposed explanatory note disclosures for Management's Adjustments, which we believe may be less relevant to Autonomous Entity Adjustments: the estimated time frame for completion and, to the extent known, the reportable segments, products, services, and processes involved; the material resources required, if any, and the anticipated timing.

<sup>327</sup> Some commenters requested clarification about what disclosure would be necessary to satisfy this requirement, with at least one of these commenters stating its belief that the proposed requirement is a subjective standard. *See, e.g.*, letters from Crowe, DT, EY, and RSM. We observe that the Rule 11-01(a)(7) requirement for pro forma financial information that includes Autonomous Entity Adjustments—namely, that the registrant previously was a part of another entity and such presentation is necessary to reflect operations and financial position of the registrant as an autonomous entity—involves a facts and circumstances determination that does not lend itself to developing an all-inclusive list of disclosures. Instead, the amended rule requires application of judgment to identify “additional” qualitative disclosures, “if any,” necessary to achieve a fair and balanced presentation in light of a registrant's unique facts and circumstances. As with other disclosure obligations, this requirement should be assessed from the perspective of the reasonable investor.

<sup>328</sup> *See* Rule 11-02(a)(11) and Rule 11-02(c)(2). We are explicitly requiring this labeling and presentation in Article 11 to avoid confusing or inconsistent disclosure. The rules also generally preclude: (i) 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, (ii) presentation of summaries of pro forma financial information that exclude material transactions, (iii) presentation of pro forma amounts that reflect Management's Adjustments elsewhere in a filing without also presenting with equal or greater prominence the amounts to which they are required to be reconciled and a cross-reference to that reconciliation, or (iv) presentations that give pro forma effect to the adoption of accounting standards.

<sup>329</sup> *See* Rule 11-02(b)(4).

comprehensive income, such as that of an acquired business, it must be brought up to within one fiscal quarter, if practicable.<sup>330</sup>

## **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 percent significance threshold, rather than the 20 percent 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 percent threshold for both acquisitions and dispositions to require disclosure of certain details of the transaction.<sup>331</sup> The terms “business” and “significant” used in Form 8-K specifically reference Article 11 of Regulation S-X.

### **a. Proposed Amendments**

The Commission proposed to:

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<sup>330</sup> See Rule 11-02(c)(3). This change better accommodates 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.

<sup>331</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 percent of the total assets of the registrant and its consolidated subsidiaries; or (ii) if it involved a business (*see* Rule 11-01(d)) that is significant (*see* Rule 11-01(b)).”

- Raise the significance threshold for the disposition of a business from 10 percent to 20 percent to conform to the threshold at which an acquired business is significant under Rule 3-05;
- To the extent applicable, conform the tests used to determine significance of a disposed business to those used to determine significance of an acquired business; and
- 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.

**b. Comments**

Commenters generally supported raising the threshold for significant dispositions.<sup>332</sup>

One commenter recommended aligning the criteria for measuring the significance of the disposition of a real estate operation with the criteria for measuring an acquisition.<sup>333</sup>

**c. Final Amendments**

We are adopting the amendments substantially as proposed. We believe these amendments will simplify compliance for registrants, and we 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.

We are amending Rule 11-01(b) to raise the significance threshold for the disposition of a business from 10 percent to 20 percent and to conform, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine significance of an

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<sup>332</sup> See letters from Bass Berry, Cravath, Eli Lilly, FEI, Liberty, NAREIT, Shearman, and Williams.

<sup>333</sup> See letter from DT.

acquired business. We are also adopting as proposed the amendment to 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>334</sup>

The amendments apply to dispositions of real estate operations as defined in Rule 3-14(a)(2).<sup>335</sup> We are not adopting for dispositions of real estate operations the last sentence of proposed Rule 1-02(w)(1)(i)(D), which modified the Investment Test to include debt secured by the real properties that is assumed by the buyer when the registrant's and its other subsidiaries' investments in and advances to the real estate operations are being compared to total assets of the registrant. Where real estate operations have been included in the consolidated financial statements of the registrant, the information necessary to apply the Investment, Asset and Income Tests is available. Thus, unlike for acquisitions of real estate operations, there are no unique industry considerations warranting limiting the significance determination to only the Investment Test or modifying that test.

### **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 issuer relying on Regulation A to present the pro forma financial information specified by Rule

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<sup>334</sup> The Form 8-K requirement for smaller reporting companies to provide pro forma financial information refers 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, as proposed, we are removing Rule 8-03(b)(4) and revising Rule 8-05 to require disclosure of pro forma financial information when any of the conditions in Rule 11-01 is met.

<sup>335</sup> See Rule 11-01(b)(2).

8-05.<sup>336</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 information 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.

**a. Proposed Amendments**

The Commission proposed 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.

**b. Comments**

No commenters offered specific comment on these proposed amendments. Two commenters generally supported the proposal to conform the rules applicable to smaller reporting companies to the generally applicable rules stating that it will codify current practice, reduce confusion, and simplify application of the rules.<sup>337</sup> In contrast, another commenter recommended that the Commission consider whether issuers relying on Regulation A warrant different treatment under the rules.<sup>338</sup> Another commenter recommended that smaller registrants

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<sup>336</sup> See paragraph (b)(7)(iv) of Part F/S. Part F/S of Form 1-A permits the periods presented to be the shorter of those applicable to issuers relying on Regulation A and the periods specified by Article 8.

<sup>337</sup> See letters from BDO and Cravath.

<sup>338</sup> See SBCFAC Recommendations.

be exempt from mandatory Management's Adjustments disclosure in pro forma financial information.<sup>339</sup>

**c. Final Amendments**

We are adopting the amendments to Rule 8-05 as proposed to require that the preparation, presentation, and disclosure of pro forma financial information by smaller reporting companies substantially comply with Article 11.<sup>340</sup> Additionally, because Part F/S of Form 1-A refers to Rule 8-05, the amendments to Rule 8-05 will apply to issuers relying on Regulation A.<sup>341</sup>

These revisions should ease compliance burdens and clarify the application of our rules for smaller reporting companies and issuers relying on Regulation A by focusing them on the more complete and better understood provisions of Article 11 and provide investors with more uniform information upon which to make their investment decisions.<sup>342</sup> As revised, in limited circumstances smaller reporting companies and issuers relying on Regulation A will now have to provide pro forma financial information for two years when the transaction for which pro forma effect is being given, such as a combination of entities under common control or discontinued operation, will be retrospectively reflected in the historical financial statements of smaller

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<sup>339</sup> See letter from EY.

<sup>340</sup> See 8-05(b). However, because pro forma financial information begins with the historical financial statements of the registrant, revised Rule 8-05 requires application of Rule 8-03(a) requirements for condensed format rather than the requirement in Rule 11-02(b)(3).

<sup>341</sup> Certain related requirements applicable to smaller reporting companies do not apply to issuers relying on Regulation A. For example, issuers relying on Regulation A are not required to file reports on Form 8-K or proxy statements.

<sup>342</sup> See Section II.D.1.

reporting companies and issuers relying on Regulation A for all periods presented as required by U.S. GAAP.<sup>343</sup>

We are also amending Rule 8-05 as proposed to require presentation of pro forma financial information when the conditions in Rule 11-01 exist.<sup>344</sup> Because Rule 8-05 currently requires pro forma financial information only for business acquisitions,<sup>345</sup> when Rule 8-05 applies, conforming its conditions to Rule 11-01 will require smaller reporting companies and issuers relying on Regulation A to provide pro forma financial information for significant acquisitions and dispositions<sup>346</sup> and when a roll-up transaction as defined in 17 CFR 229.901(c) occurs, the registrant previously was a part of another entity and such presentation is necessary to reflect operations and financial position of the registrant as an autonomous entity, or consummation of one or more transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors.<sup>347</sup>

#### **E. Amendments to Financial Disclosure about Acquisitions Specific to**

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<sup>343</sup> Rule 8-05 did not have a similar provision. However, the incremental burden on smaller reporting companies and issuers relying on Regulation A is not expected to be significant because the circumstances requiring retrospective revision are generally within their control and they must eventually revise their previously filed historical financial statements for all periods to reflect these circumstances.

<sup>344</sup> See Rules 8-05(a) and 11-01(a), as amended.

<sup>345</sup> See *supra* Section II.D.2.

<sup>346</sup> Based on an analysis of 2017 disclosures of acquisitions and dispositions by smaller reporting companies, Commission staff found that out of 191 disclosures of acquisitions and dispositions by smaller reporting companies in 2017, 178 already appeared to comply with Article 11 requirements. Based on an analysis of disclosures of acquisitions and dispositions in Forms 1-A originally filed in 2019, Commission staff found that out of 12 Forms 1-A that disclosed acquisitions subject to Rule 8-04 or Rule 8-06, 9 already appeared to comply with Article 11 requirements.

<sup>347</sup> Form 1-A requires the pro forma financial information described in Rule 8-05 only when financial statements are required for businesses acquired or to be acquired. We have amended Part F/S of Form 1-A to remove this limitation to be consistent with our amendments, as proposed, to Rule 8-05 to require presentation of pro forma financial information when the conditions in Rule 11-01 exist.

## 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>348</sup> unless subject to the special rules set forth in 17 CFR 210.6-01 through 6-10 (“Article 6”).<sup>349</sup> Investment company registrants differ from non-investment company registrants in several respects.<sup>350</sup> The Commission proposed amendments to tailor the financial reporting requirements for investment companies with respect to their acquisitions of investment companies and other types of funds (collectively, “acquired funds”). Specifically, the Commission proposed:

- 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>351</sup>
- To add new Rule 6-11 of Regulation S-X, which would specifically cover financial reporting in the event of a fund acquisition; and

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<sup>348</sup> In October 2016, as part of a broader investment company reporting modernization rulemaking, the Commission adopted certain amendments to Regulation S-X that 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>349</sup> *See* Rule 6-03.

<sup>350</sup> *See* Section II.E. of the Proposing Release. Investment companies invest in securities principally for returns from capital appreciation and investment income. Investment companies are required to value their portfolio investments, with changes in value recognized in the statement of operations for each reporting period. *See* Rule 6-02(b) (“the term value shall have the same meaning given in Section 2(a)(41)(B) of the Investment Company Act”); *see also* FASB ASC 946-320-35, FASB ASC 946-323, FASB ASC 946-325-35, FASB ASC 946-810, and FASB ASC 815-10-35. Also, investment companies generally do not consolidate entities they control and do not account for portfolio investments using the equity method. *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>351</sup> The Commission additionally proposed 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)).

- To eliminate the pro forma financial information requirement for investment companies and replace it with proposed supplemental financial information that the Commission believed would be more relevant to fund investors.

Commenters generally supported the Commission’s objective of tailoring financial reporting requirements for investment companies with respect to acquired funds.<sup>352</sup> As discussed below, we are adopting these requirements substantially as proposed, with certain modifications based on comments received.

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

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.<sup>353</sup> However, the tests in Rule 1-02(w) were not written for the specific characteristics of investment companies.<sup>354</sup> As detailed in the Proposing Release, the definition of “significant subsidiary” in current Rule 1-02(w) has an Investment Test, an Asset Test, and an Income Test, while the definition of “significant subsidiary” in Rule 8b-2 has an investment test and an income test, but no asset test.<sup>355</sup> The Commission proposed to add new Rule 1-02(w)(2) to create a separate definition of “significant subsidiary” for investment companies in Regulation S-X, which—like Rule 8b-2—would use an investment test and an income test, but not an asset test.<sup>356</sup>

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<sup>352</sup> See letters from BDO, CAQ, Deloitte, and Investment Company Institute (“ICI”).

<sup>353</sup> The changes to the “significant subsidiary” definition in Regulation S-X will 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.

<sup>354</sup> See Proposing Release at n. 217 and accompanying text.

<sup>355</sup> See Section II.E.1. of Proposing Release.

<sup>356</sup> *Id.* The Commission also proposed conforming amendments to the definition of “significant subsidiary” in Securities Act Rule 405, Exchange Act Rule 12b-2, and Investment Company Act Rule 8b-2 to make them consistent with proposed Rule 1-02(w)(2).

Two commenters supported adding a definition of “significant subsidiary” specifically tailored for investment companies.<sup>357</sup> One commenter noted that certain language in proposed Rule 1-02(w)(1) appeared inconsistent with proposed Rule 1-02(w)(2).<sup>358</sup>

**a. Investment Test**

Currently, the Investment Test for a significant subsidiary in Regulation S-X determines significance by evaluating whether the registrant’s and its other subsidiaries’ investments in and advances to the tested subsidiary<sup>359</sup> exceed 10 percent of the registrant’s total assets. Rule 8b-2 similarly determines significance using an investment test. For investment companies, the Commission proposed an investment test that would assess whether the value of the registrant’s and its other subsidiaries’ investments in and advances to the tested subsidiary exceeds 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. The 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 rather than total assets.<sup>360</sup>

We are adopting, as proposed, the investment test for investment companies as part of the definition of “significant subsidiary.” We received one comment on the proposed investment test. This commenter supported the proposed investment test for investment companies, agreeing that investment in the tested subsidiary in the context of its relative exposure to total

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<sup>357</sup> See letters from ICI and KPMG.

<sup>358</sup> See letter from EY. Specifically, proposed Rule 1-02(w)(1) stated that the conditions of paragraph (w)(2) would apply if the “subsidiary” is a registered investment company or a business development company, but paragraph (w)(2) stated that its provisions apply to a “registrant” that is a registered investment company or a business development company. We have revised Rule 1-02(w)(1) to state that the tests in Rule 1-02(w)(2) apply if the registrant is a registered investment company or a business development company.

<sup>359</sup> See *supra* note 29 (regarding the use of the term “tested subsidiary”).

<sup>360</sup> See 17 CFR 210.6-04.4.

investments at fair value is the appropriate metric in evaluating its significance.<sup>361</sup> We continue to believe that a total investments measure is more appropriate for investment companies and more relevant than the existing tests, as 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.<sup>362</sup>

**b. Asset Test**

The Asset Test in current 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 under the Rule 8b-2 definition of "significant subsidiary".

As proposed, we are eliminating the Asset Test as a measure of significance for investment companies because we continue to believe that doing so would simplify compliance without changing the information available to investors as the Asset Test is generally not meaningful when applied to investment companies. The only commenter who addressed this aspect of the proposal expressed support for the elimination of the Asset Test, stating that it is not meaningful when applied to investment companies and has been confusing for business development companies to practically apply.<sup>363</sup>

**c. Income Test**

The Income Test in current Rule 1-02(w) compares the registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes of the tested

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<sup>361</sup> See letter from Ares Capital Corporation ("Ares").

<sup>362</sup> We also continue to believe that using total investments for this test would be a more transparent measure than total assets for registrants that use a statement of net assets instead of a balance sheet. See Section II.E.1.a. of Proposing Release.

<sup>363</sup> See letter from Ares.

subsidiary exclusive of amounts attributable to any noncontrolling interests with the income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. The income test in Rule 8b-2, however, compares the total investment income of the tested subsidiary with the total investment income of the parent and its consolidated subsidiaries. Both tests find significance if the result is greater than 10 percent.

**i. Proposed Amendments**

The Commission proposed to amend the income test for investment companies to use the income test in Rule 8b-2, 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 would use 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. The absolute value of the sum of these amounts would be compared to the absolute value of the registrant and its subsidiaries' consolidated change in net assets resulting from operations. The Commission also proposed that a tested subsidiary would be deemed significant under the income test for investment companies if the test yields a condition of greater than either: (1) 80 percent by itself, or (2) 10 percent *and* the investment test for investment companies yields a result of greater than 5 percent ("alternate income test").

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, the Commission proposed an instruction that would permit

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.

## ii. Comments

One commenter specifically supported the proposed income test for investment companies with an 80 percent threshold and the proposed alternate income test with 10 percent and five percent thresholds.<sup>364</sup> However, a different commenter requested that the Commission increase the five percent threshold for the investment component of the alternate income test to 10 percent, consistent with the investment test and Rule 8b-2(b),<sup>365</sup> and another commenter suggested that the Commission eliminate the proposed primary income test and adopt only the alternate income test.<sup>366</sup>

Several commenters recommended the Commission clarify the order of operations for the proposed income test, in particular whether the numerator should be the absolute value of the sum of the constituent elements or, instead, the sum of the absolute value of each of the constituent elements.<sup>367</sup> Commenters generally supported the former approach because it would avoid double counting of a gain (or loss) related to a sale previously recorded as an unrealized gain (or loss).<sup>368</sup> One commenter recommended that the income test be limited only to investment income as changes in gains and losses would be captured by the investment test.<sup>369</sup>

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<sup>364</sup> See letter from ICI.

<sup>365</sup> See letter from Ares.

<sup>366</sup> See letter from KPMG.

<sup>367</sup> See letters from Ares, BDO, CAQ, Deloitte, KPMG, ICI, and RSM.

<sup>368</sup> See letters from BDO, CAQ, Deloitte, EY, and KPMG.

<sup>369</sup> See letter from Ares.

Two commenters also observed that the methods for determining the numerator and the denominator of the income test were different and questioned the potential impact on the test.<sup>370</sup>

One commenter expressed support for the ability of the registrant to use the five-year average of the change in net assets from operations where the most recent fiscal year's change in net assets is insignificant.<sup>371</sup> Several commenters, however, preferred a bright-line threshold of 10 percent lower than the average change in net assets resulting from operations for the past five years rather than the "insignificant" standard.<sup>372</sup> Several commenters also recommended that five-year averaging be used for the 80 percent test as well as the alternate income test.<sup>373</sup>

### **iii. Final Amendments**

We are adopting amendments to the income test substantially as proposed, but with some modifications after consideration of the comments received. Commenters supported the percentage thresholds in the income test. We are not increasing the investment component of the alternate income test to 10 percent of total investments, as one commenter suggested, because we believe that would render the alternate income test duplicative of the 10 percent threshold in the investment test. We also continue to believe that exceeding an 80 percent threshold in income alone may indicate significance for financial reporting purposes for a subsidiary even if the related assets represent less than 5 percent of total investments. We are, therefore, adopting this prong of the income test as proposed.

In response to commenters, we have revised the calculation of income to be the absolute value of "the sum" of combined investment income from dividends, interest, and other income,

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<sup>370</sup> See letters from Ares and IMA.

<sup>371</sup> See letter from ICI.

<sup>372</sup> See letters from BDO, CAQ, KPMG, and EY.

<sup>373</sup> See letters from BDO, CAQ, EY, ICI, PwC, Small Business Investor Alliance ("SBIA"), and RSM.

the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments. We believe this modification will prevent confusion in applying absolute value with respect to income and avoid the potential double counting of gains or losses. We continue to believe that 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.<sup>374</sup> We also believe it is appropriate to compare the specified income elements received from the tested subsidiary<sup>375</sup> with the investment company registrant's change in net assets resulting from operations in order to evaluate the impact on the registrant's net income, particularly in the context of the subsidiary being a single portfolio investment. However, we agree that this approach is less relevant in the event of a fund acquisition since the acquired fund is likely to have fund-level expenses that should be netted against income. We have, therefore, modified the language to state that, for purposes of Rule 6-11, the income determination is made by comparing the absolute value of the change in net assets resulting from operations of the tested subsidiary with that of the investment company registrant.

We are modifying the five-year income averaging provision, as suggested by commenters, to provide a bright-line threshold at 10 percent lower than the average change in net assets resulting from operations for the past five years rather than the "insignificant" standard in order to reduce potential inconsistencies in application.<sup>376</sup> As proposed, the five-year averaging provision applies to the income test, which would include both the 80 percent condition in the primary income test and the 10 percent condition in the alternate income test; however, in light

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<sup>374</sup> See Section II.E.1.c. of Proposing Release.

<sup>375</sup> Rule 1-02(w)(2)(ii) covers the specified income elements "from the tested subsidiary" and is calculated at the registrant-level.

<sup>376</sup> See Rule 1-02(w)(2)(ii).

of commenter confusion, we have clarified the rule text to expressly state that it applies to both conditions.<sup>377</sup>

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

Currently, 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. 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 exclusions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. These private funds often have prepared audited financial statements in accordance with U.S. GAAP, but generally have not prepared their financial statements in accordance, nor had an audit conducted in compliance, with Regulation S-X. 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.

### **a. Proposed Amendments**

The Commission proposed Rule 6-11, which would specifically cover financial reporting in the event of a fund acquisition. 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.

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<sup>377</sup> *Id.*

Because the definition of business in Rule 11-01(d) is not readily applicable in the context of a fund acquisition, the Commission proposed 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.

The Commission proposed 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, and to make the obligations more aligned with the financial statement obligations applicable to investment company registration statements.<sup>378</sup> Proposed Rule 6-11 would require the related schedules specified in Article 12, such as the schedule of investments, to be provided for an acquired or to be acquired fund. Acquisitions of a group of related funds would be considered as a single acquisition under proposed Rule 6-11(a)(3)<sup>379</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.

The Commission proposed to allow investment companies to provide financial statements for private funds that were prepared in accordance with U.S. GAAP. The Commission also proposed 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

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<sup>378</sup> 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>379</sup> Funds would be 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.

separately.<sup>380</sup>

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 percent for 10 percent for each place it appears therein.<sup>381</sup> If either of the tests were satisfied at the 20 percent 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 were to exceed the conditions of the investment test and the alternate income test for investment companies, substituting 50 percent for 10 percent, then the registrant would be required to provide the financial statements for each individually insignificant fund and the supplemental financial information.<sup>382</sup> In determining whether financial statements of funds acquired or to be acquired must be filed, the registrant would be permitted to 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-

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<sup>380</sup> Because proposed Rule 6-11 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.

<sup>381</sup> As proposed, the primary income test for investment companies with the 80 percent condition would not be used for purposes of proposed Rule 6-11.

<sup>382</sup> The Commission based the 50 percent 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.

01 or 3-18 is filed for a date after the date the acquisition was consummated.<sup>383</sup>

## **b. Comments**

Commenters generally supported the Commission’s objective of tailoring financial reporting requirements for investment companies with respect to acquired funds.<sup>384</sup> Commenters questioned the scope of the definition of fund acquisition, suggesting that proposed Rule 6-11 might technically apply whenever a fund acquires an equity interest in another fund<sup>385</sup> or when the portfolio securities acquired represent only a portion of another fund’s holdings but will represent substantially all of the initial assets of a new registrant.<sup>386</sup> A number of commenters also requested guidance on when Rule 3-05 would apply to non-fund acquisitions by investment company registrants.<sup>387</sup>

One commenter supported proposed Rule 6-11’s use of the “significant subsidiary” definition, modified to set the investment test at the 20 percent condition and to exclude the primary income test with the 80 percent condition.<sup>388</sup> This commenter recommended that the alternate income test be changed from five percent to 10 percent of total investments because the size of the acquired fund should be the principal determinant of significance. Two commenters questioned whether the significance tests would only apply to fund acquisitions covered in

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<sup>383</sup> At such time, the acquired investments would be reflected on the balance sheet or statement of net assets and accompanying schedules. In proposing this approach, the Commission expressed its belief that in these circumstances 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 and 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. *See* Section II.E.2. of Proposing Release.

<sup>384</sup> *See* letters from BDO, CAQ, Deloitte, and ICI.

<sup>385</sup> *See* letters from CAQ, EY, and GT.

<sup>386</sup> *See* letters from EY and KPMG.

<sup>387</sup> *See* letters from CAQ, Deloitte, EY, GT, ICI, KPMG, and PwC.

<sup>388</sup> *See* letter from ICI.

proposed Rule 6-11(b)(2) and not proposed Rule 6-11(b)(1).<sup>389</sup>

One commenter supported the proposed alignment of financial statement requirements with Rule 3-18, but expressed confusion about whether acquired fund financial statements would need to be included in subsequent filings until a post-acquisition audited balance sheet is filed.<sup>390</sup> Another commenter indicated that it was unclear as to the number of fiscal years for which financial statements must be presented for acquired funds, whether only for the past fiscal year or for the periods set forth in Rule 3-18.<sup>391</sup> A third commenter stated that proposed Rule 6-11 should eliminate reporting requirements for acquired companies that have previously filed audited financial statements with the Commission in accordance with Regulation S-X and allow unaudited financial statements for other acquired companies due to cost.<sup>392</sup>

Regarding the proposal to permit acquired private funds to provide financial statements prepared in accordance with U.S. GAAP and schedules that comply with Article 12, one commenter supported the proposed approach.<sup>393</sup> Two commenters requested that the Commission consider alternatives that would provide full transparency of the portfolio holdings of the acquired fund but not require audited Article 12 schedules.<sup>394</sup>

Several commenters suggested that the Commission make various amendments to Rules 3-09, 4-08(g), and 10-01(b)(1) of Regulation S-X, involving financial disclosures outside of the acquisition context.<sup>395</sup>

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<sup>389</sup> See letter from EY and ICI.

<sup>390</sup> See letter from ICI.

<sup>391</sup> See letter from EY.

<sup>392</sup> See letter from Ares.

<sup>393</sup> See letter from ICI.

<sup>394</sup> See letters from ICI and KPMG.

<sup>395</sup> See letters from Ares, BDO, KPMG, and SBIA.

### c. Final Amendments

We are adopting new Rule 6-11 to address the financial disclosure obligations for acquired funds, with certain modifications in response to comments received.<sup>396</sup> Investment company registrants will follow Rule 6-11, rather than Rule 3-05, in the event that a fund acquisition occurs or is probable to occur.<sup>397</sup> With respect to whether a fund acquisition has occurred, in response to commenters who sought further clarity, we have revised Rule 6-11(a)(2)(ii) to state that in evaluating the facts and circumstances as to whether an acquisition has occurred or is probable, a registrant should consider whether it will result in the acquisition of all or substantially all of the portfolio investments held by another fund.<sup>398</sup> We have also removed language that suggests acquired fund financial disclosure would be required if the registrant acquired a non-substantial portion of another fund's portfolio investments that would constitute all or substantially all of the initial assets of the registrant.<sup>399</sup> The intent of the facts and circumstances evaluation is to capture all situations where additional disclosure about the acquired fund is appropriate, regardless of the legal form, such as merger, consolidation, or asset sale, used to structure the transaction.

We are adopting the use of the "significant subsidiary" definition in Rule 1-02(w)(2) as the basis for determining whether financial statements for the acquired fund must be filed under Rule 6-11, but modified, as proposed, to use the investment test at the 20 percent condition and

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<sup>396</sup> We also are adopting, as proposed, conforming amendments to Rules 3-18(d), 5-01(a), 6-01, 6-02(b) and (c), and 6-03 of Regulation S-X to reflect the addition of Rule 6-11.

<sup>397</sup> Investment company registrants are currently subject to the requirements of Rule 3-05, provided the conditions set forth in that rule are satisfied. Rule 3-05, as revised, will continue to apply to investment company registrants with respect to acquired and disposed businesses that do not involve a fund acquisition covered by Rule 6-11.

<sup>398</sup> Rule 6-11(a).

<sup>399</sup> *Id.*

to exclude the 80 percent condition of the primary income test. We are not altering the investment component of the alternate income test, as one commenter suggested, because we continue to believe that five percent of total investments represents a material threshold.<sup>400</sup> As adopted without change from the proposal, the significance tests in Rule 6-11 only apply to situations covered in paragraph (b)(2) and not paragraph (b)(1). Thus, an investment company registrant filing a registration statement on Form N-14 in connection with the acquisition of another fund will not apply the significance tests in Rule 6-11(b)(2).

As proposed, Rule 6-11 would have required an investment company registrant to include acquired fund financial statements as part of the registrant's financial statements until its next audited balance sheet after the acquisition was consummated. Given the availability of the acquired fund financial statements on the Commission's EDGAR system once filed and that the price of investment company shares or interests is established by the value of its current investment portfolio, we agree with commenters that acquired fund financial statements need not be included in future filings. Accordingly, we have modified the rule to require acquired fund financial statements to be filed only once.<sup>401</sup>

One commenter requested clarification of the number of fiscal years for which financial statements must be presented in Rule 6-11 and whether the requirement should be consistent

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<sup>400</sup> The modified conditions in Rule 6-11 only substitute 20 percent for 10 percent for the investment test and alternate income test described in Rule 1-02(w)(2). Thus, for purposes of Rule 6-11, a registrant would apply an investment test condition of 20 percent of the value of total investments and the alternate income test conditions of 20 percent of the absolute value of the change in net assets resulting from operations and five percent of the value of total investments.

<sup>401</sup> Rule 6-11(b)(4). Proposed Item 14(d)(5) of Schedule 14A [17 CFR 240.14a-101] would have required proxy statements filed by a fund, with respect to a merger, consolidation, acquisition, or similar matter, to include financial statements of the acquiring fund, including those required by Rules 3-05 and 6-11 and Article 11 of Regulation S-X "with respect to transactions other than that as to which action is to be taken as described" in the proxy statement. Since Rule 6-11 only requires acquired fund financial statements to be filed once, we are not adopting the proposed amendment to Item 14(d)(5) of Schedule 14A.

with Rule 3-18.<sup>402</sup> In response, we have revised Rule 6-11 to make clear that if the acquired fund is subject to Rule 3-18, then the financial statements for the periods described in Rule 3-18 shall be filed.<sup>403</sup> For all other acquired funds, such as private funds, only the financial statements for the most recent fiscal year and the most recent interim period need to be filed.<sup>404</sup> We are not following the suggestion, made by one commenter, to eliminate the filing of acquired fund financial statements if they were previously filed with the Commission in accordance with Regulation S-X by the acquired fund, because the disclosure is predominantly for the benefit of the acquiring fund's shareholders, not the acquired fund's shareholders.<sup>405</sup>

We are not persuaded by the commenter who requested that we permit filing of unaudited financial statements for acquired funds due to cost. We continue to believe 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>406</sup> Moreover, although auditing an acquired private fund's financial statements involves costs, we believe that our proposed approach requiring audited U.S. GAAP financial statements with respect to acquisitions of private funds will reduce costs as compared to re-issuing audited financial statements in compliance with Regulation S-X, but still will provide investors appropriate information about

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<sup>402</sup> Rule 3-18 applies to registered management investment companies. Business development companies are also permitted to use Rule 3-18 pursuant to the instructions set forth in Form N-2.

<sup>403</sup> Rule 6-11(b)(2)(ii) and (iii).

<sup>404</sup> *Id.*

<sup>405</sup> Some forms, such as Form N-14, permit backwards incorporation by reference of information not included in the prospectus. *See* General Instruction G to Form 14. Effective May 2, 2019, incorporation by reference on Form N-14 is allowed for all parties who may use the form, including business development companies. *See FAST Act Modernization and Simplification of Regulation S-K*, Release No. IC-10618 (Mar. 20, 2019) [84 FR 12674 (Apr. 2, 2019)].

<sup>406</sup> For example, private funds prepare audited financials, among other reasons, to satisfy their custody rule obligations under the Investment Advisers Act. *See* 17 CFR 275.206(4)-2.

the acquired fund. We also have modified Rule 6-11(c) from the proposal to make the filing of financial statements using U.S. GAAP permissive for private funds. Proposed Rule 6-11(c) provided that the financial statements of private funds “shall” comply with U.S. GAAP. Under the final rule, the financial statements of private funds may either comply with U.S. GAAP or Article 12.<sup>407</sup>

The Commission’s proposal was intended to achieve a more appropriate balance by permitting registrants to file audited U.S. GAAP financial statements for acquired private funds, but supplementing those financial statements with audited schedules listing each investment as required by Article 12.<sup>408</sup> A condensed schedule of investments prepared under U.S. GAAP does not include the same prescriptive level of detail when compared to an Article 12 compliant (or full) schedule of investments. While each investment is listed separately in a full schedule of investments, a condensed schedule allows funds to aggregate investments by issuer or by investment type so long as each investment is individually less than five percent of the net assets of the fund.<sup>409</sup> While providing a full unaudited schedule of portfolio investments would provide transparency, we believe that the incremental costs of providing an audited schedule of investments that complies with Article 12 is minimal because the portfolio investment account balances already have been audited, and the incremental audit procedures therefore would be limited to the incremental disclosures required under Article 12. In addition, an audit will provide additional assurance for investors as to the accuracy of that schedule.

We also are removing the sentence from proposed Rule 6-11(a)(3) providing that the

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<sup>407</sup> We also have made non-substantive changes to provide a more accurate heading for paragraph (c) and to reflect the intent of the Commission that the provision applies to a fund or private account that is “acquired or to be acquired.” As proposed, the language only referenced a fund or private account “to be acquired.”

<sup>408</sup> See Section II.E.2. of Proposing Release.

<sup>409</sup> See FASB ASC 946.

financial statements in connection with the acquisition of a group of related funds may be presented either on an individual or a combined basis for any periods the related funds are under common control or management. This change is based on our understanding that, unlike operating companies, funds generally do not file “combined financial statements” as defined in FASB ASC Topic 810-10-20.

Finally, with respect to commenters’ suggestion to make substantive amendments to Rules 3-09, 4-08(g), and 10-01(b)(1) of Regulation S-X, we believe such amendments would be beyond the scope of this rulemaking.<sup>410</sup>

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

Currently, 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 percent for 10 percent in the conditions.<sup>411</sup>

#### **a. Proposed Amendments**

The Commission proposed to replace the pro forma financial disclosures requirement with proposed Rule 6-11(d), which would require that investment company registrants provide supplemental financial information about the newly combined entity that it believed would be more relevant to investors.<sup>412</sup> The proposed supplemental financial information would include: (1) A pro forma fee table, setting forth the post-transaction fee structure of the combined entity;

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<sup>410</sup> While we are not making substantive changes to Rule 3-09, as a result of the changes to Rule 1-02(w) we are revising Rule 3-09(a) to make clear that it applies to Rule 1-02(w)(1).

<sup>411</sup> 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. *See* Rule 11-02(b)(1).

<sup>412</sup> *See* Section II.E.3. of Proposing Release.

(2) If the transaction will result in a material change in the acquired fund’s investment portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to show the effects of such change and accompanied by narrative disclosure describing the change; and  
(3) Narrative disclosure about material differences in accounting policies of the acquired fund when compared to the newly combined entity.

**b. Comments**

One commenter expressed support for the proposed replacement of the pro forma financial information requirement, indicating that the proposed supplemental financial information would better inform investors and reduce costs.<sup>413</sup> In addition, two commenters noted that the rule text in proposed Rule 6-11(d)(1)(iii) would require disclosure about material differences in “financial and operating policies,” while the preamble of the Proposing Release referred to material differences in “accounting policies” between the acquiring and acquired funds.<sup>414</sup>

**c. Final Amendments**

We are adopting the amendments substantially as proposed, but with one modification in response to comments received. As proposed, we are adopting amendments to eliminate the requirement to provide pro forma financial information for investment company registrants in connection with fund acquisitions and to require the supplemental financial information in its place.<sup>415</sup> We believe that the pro forma financial information is not necessary in light of the costs to prepare such disclosures and given that the supplemental financial information will provide material information to investors by highlighting important changes resulting from a

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<sup>413</sup> See letter from ICI.

<sup>414</sup> See letters from EY and ICI.

<sup>415</sup> See Section II.E.4. of Proposing Release.

fund acquisition as context for the acquired fund’s financial statements. We also are modifying Rule 6-11(d)(1)(iii) to state that it requires narrative disclosure about material differences in “accounting policies” of the acquired fund when compared to the acquiring fund, which was the Commission’s intent as expressed in the preamble of the Proposing Release.

#### **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>416</sup> provides, subject to certain exceptions, that the corresponding Statement of Additional Information (“SAI”) “shall contain the financial statements and schedules of the acquiring company and the company to be acquired required by Regulation S-X.”

##### **a. Proposed Amendments**

The Commission proposed to amend Form N-14 to make its disclosure requirements consistent with the disclosures required in proposed Rule 6-11. Specifically, the Commission proposed the following amendments:

- In the case of a fund acquisition, any financial statements and schedules required by Regulation S-X would only be required for the most recent fiscal year and the most recent interim period;<sup>417</sup>
- Permit private funds to provide financial statements and schedules that conform to U.S. GAAP and Article 12 of Regulation S-X;

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<sup>416</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>417</sup> Non-fund acquisitions would continue to 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.

- Require inclusion of the supplemental financial information described in proposed Rule 6-11(d), except for the pro forma fee table;<sup>418</sup>
- Remove provisions no longer relevant because of prior amendments;<sup>419</sup> and
- 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 percent of the registrant's net asset value, because pro forma financial statements would no longer be required for fund acquisitions and, for non-fund acquisitions, the significance measure for pro forma financial statements in Rule 11-01(b)(1) is and will remain 20 percent.

#### **b. Comments**

Two commenters noted that the rule text of the proposed amendments to Item 14.2 of Form N-14, which describes the financial statement requirements when the acquired fund is a private fund, differed from the rule text of proposed Rule 6-11(c).<sup>420</sup>

#### **c. Final Amendments**

We are amending Form N-14 substantially as proposed, but with some modifications in response to commenters. We continue to believe that it is appropriate for investors who acquire securities in a registered offering to have the same disclosure that investors receive through

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<sup>418</sup> The Commission proposed to exclude 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.

<sup>419</sup> Specifically, the Commission proposed to remove 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 Registration Form Used by Open-End Management Investment Companies: Guidelines*, Release No. IC-13436 (Aug. 12, 1983) [48 FR 37928 (Aug. 22, 1983)]. 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)].

<sup>420</sup> *See* letter from EY (stating that proposed Item 14.2 of Form N-14 included text that was not included in proposed rule 6-11(c)); *see also* letter from ICI (same).

financial statement disclosure in shareholder reports. With respect to Item 14.2, we agree with commenters that there should be consistency between the Form N-14 and Rule 6-11 disclosure requirements for private funds using U.S. GAAP, and we have made conforming amendment to Form N-14 to reflect Rule 6-11 as adopted.<sup>421</sup>

## **F. Transition**

After considering feedback from commenters,<sup>422</sup> registrants will not be required to apply the final amendments until the beginning of the registrant’s fiscal year beginning after December 31, 2020 (the “mandatory compliance date”). Acquisitions and dispositions that are probable or consummated after the mandatory compliance date must be evaluated for significance using the final amendments.<sup>423</sup>

Registrants filing initial registration statements are not required to apply the final amendments until an initial registration statement is first filed on or after the mandatory compliance date. For initial registration statements first filed on or after the mandatory

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<sup>421</sup> Item 4.2 of Form N-14.

<sup>422</sup> *See e.g.*, letters from BDO, DT, EY, and KPMG. BDO recommended permitting application of the amendments in filings made on or after publication of the amendments in the Federal Register. DT indicated it may be useful for preparers to understand whether the new rules should be applied to all acquisitions (1) Consummated after the effective date, (2) Reported on Form 8-K or 8-K/A filed after the effective date, or (3) Reported in a new or amended registration statement filed after the effective date and when registrants would apply the new pro forma requirements, particularly if some acquisitions were consummated before the effective date and others were consummated after. EY recommended that registrants that have filed a current report announcing the completion of a significant acquisition or disposition before the effective date of the final rule be allowed to comply with the existing rules for that transaction and registrants that have submitted a draft or confidential registration statement or filed a registration statement before the effective date of the final rule be allowed to complete their offering under the existing rules. KPMG recommended that the Commission provide transition guidance that clarifies the effective date, including the permissibility of early application of the amendments and application of the amendments to transactions consummated near the final rule’s effective date.

<sup>423</sup> For registration statements filed on or after the mandatory compliance date, registrants that are subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act at the mandatory compliance date may test acquisitions and dispositions consummated before the mandatory compliance date using rules that were in effect when the acquisitions and dispositions were consummated.

compliance date, all probable or consummated acquisitions and dispositions, including those consummated prior to the mandatory compliance date, must be evaluated for significance using the final amendments.<sup>424</sup>

Voluntary early compliance with the final amendments is permitted<sup>425</sup> in advance of the registrant's mandatory compliance date provided that the final amendments are applied in their entirety from the date of early compliance.<sup>426</sup>

### **III. Other Matters**

If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

Pursuant to the Congressional Review Act, the Office of Information and Regulatory Affairs has designated these rules a "major rule," as defined by 5 U.S.C. 804(2).

### **IV. Economic Analysis**

#### **A. Introduction**

We are adopting amendments to our rules and forms to improve their application, assist

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<sup>424</sup> Issuers relying on Regulation A filing initial offering statements on Form 1-A are not required to apply the final amendments until an initial offering statement is first filed on or after the mandatory compliance date. For initial offering statements first filed on or after the mandatory compliance date, all probable or consummated acquisitions and dispositions, including those consummated prior to the mandatory compliance date, must be evaluated for significance using the final amendments.

<sup>425</sup> To the extent that registrants have questions about application of the rules in connection with early compliance, they should reach out to Commission staff for additional transition guidance.

<sup>426</sup> For an acquisition or disposition of a business for which the disclosure required by an Item 2.01 Form 8-K has been filed (or was required to be filed) prior to the mandatory compliance date (or the voluntary early compliance date, if applicable), but for which Rule 3-05 Financial Statements and Article 11 pro forma financial information are not required to be filed (e.g., in an Item 9.01 Form 8-K) until after the mandatory compliance date (or until after the voluntary early compliance date, if applicable), the registrant must file the financial statements and pro forma financial information required by the rules in effect when the Item 2.01 Form 8-K was required to be filed.

registrants in making more meaningful determinations of whether a subsidiary or an acquired or disposed business is significant, and improve the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses, including real estate operations and investment companies. The amendments are intended to improve the utility and relevance of the financial information about acquired or disposed businesses provided to investors, facilitate timely access to capital, and reduce the complexity and costs to prepare required disclosures. The reduction in compliance costs could in theory facilitate increased acquisition or disposition activity by registrants. However, registrants engage in acquisitions and dispositions for a variety of business reasons, and, as a general matter, their evaluation of the advisability of acquisitions and dispositions often involve cost and benefit considerations much greater than compliance cost considerations. More specifically, with respect to significant transactions which could trigger disclosure relevant to the amendments, these other considerations are likely to be even more important to the decision to engage in acquisition and disposition activity than the more modest effects of the final amendments.

Providing timely, accurate, and transparent information, especially financial information, about acquired and 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>427</sup> However, in the absence of appropriately tailored disclosures, investors may not be able to optimize allocation of their resources or fully assess the effects of this important external governance mechanism on the firms in which they invest.

Disclosure requirements also impose costs on registrants that may seek to engage in acquisitions or dispositions. In particular, such costs could diminish the benefits associated with an acquisition or disposition; however, we would not expect such costs to alter a decision to pursue a particular transaction. Further, a registrant's ability to provide such disclosure for periods prior to an acquisition may be dependent on the availability and assistance of both the acquired business and the acquired business's independent auditor. While this potential issue would be unlikely to affect a registrant's decision to engage in an acquisition, it may impact its ability to comply with reporting requirements for capital raising transactions and, accordingly, to access capital in the manner and within the time frames it most desires.

We believe the final amendments, by streamlining and clarifying acquired business financial disclosure requirements, should reduce compliance costs while maintaining investors' access to information that is material to an understanding of the potential effects of an acquired or to be acquired business (or disposed or to be disposed business) on the registrant.

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>428</sup> Section 3(f) of the Exchange Act,<sup>429</sup> and

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<sup>427</sup> See, e.g., Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372 (1990) ("Mitchell & Lehn (1990)"); Anup Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, 38 J. FIN. & QUANTITATIVE ANALYSIS 721 (2003) ("Agrawal & Jaffe (2003)"). See also, e.g., Xiaoyang Li, *Productivity, Restructuring, and the Gains from Takeovers*, 109 J. FIN. ECON. 250 (2013) ("Li (2013)"). Based on plant-level data, this study shows that acquirers increase targets' productivity through more efficient use of capital and labor, thus enhancing the value of the acquisitions.

<sup>428</sup> 15 U.S.C. 77b(b).

<sup>429</sup> 17 U.S.C. 78c(f).

Section 2(c) of the Investment Company Act<sup>430</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>431</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 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 whenever 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 1-02(w), Rule 3-05, Rule 3-14, Article 11, and the related smaller reporting company requirements in Article 8 of Regulation S-X, together with current disclosure practices, form the baseline from which we estimate the likely economic effects of the amendments.<sup>432</sup>

The amendments 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

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<sup>430</sup> 15 U.S.C. 80a-2(c).

<sup>431</sup> 15 U.S.C. 78w(a)(2).

<sup>432</sup> *See supra* Section II.

may be affected, such as significant acquirees for which financial statements are required under Rule 3-05 and Rule 3-14.

The amendments may affect both domestic registrants and foreign private issuers.<sup>433</sup> We estimate that during calendar year 2019, approximately 6,792 registrants filed on domestic forms<sup>434</sup> and 849 foreign private issuers filed on F-forms, other than registered investment companies. Among the registrants that file on domestic forms, approximately 31 percent were large accelerated filers, 19 percent were accelerated filers,<sup>435</sup> and 50 percent were non-accelerated filers. In addition, we estimate that of these domestic issuers approximately 42.8 percent were smaller reporting companies and 17.2 percent of these domestic issuers were emerging growth companies.<sup>436</sup> About 26.1 percent 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 39 percent of foreign private issuers reported under U.S. GAAP, 60 percent reported under IFRS-IASB, and approximately 1 percent reported under a comprehensive body of accounting principles other than U.S. GAAP or IFRS-IASB with a

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<sup>433</sup> The number of domestic registrants and foreign private issuers affected by the amendments is estimated as the number of unique companies, identified by Central Index Key (CIK), that filed Form 10-K, Form 20-F, and Form 40-F or an amendment thereto with the Commission during calendar year 2019. The estimates for the percentages of companies by accelerated filer status and the percentage of smaller reporting companies are based on the self-reported status provided by these registrants during calendar year 2019, with supplemental data from Ives Group Audit Analytics. 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 or an amendment thereto. These estimates do not include issuers that filed only initial registration statements during calendar year 2019, which will also be affected by the amendments.

<sup>434</sup> This number includes fewer than 20 foreign private issuers that file on domestic forms and approximately 100 business development companies. Of the foreign private issuers filing on domestic forms in calendar year 2019, approximately 85 percent reported under U.S. GAAP while 15 percent reported under IFRS-IASB.

<sup>435</sup> See *supra* note 23.

<sup>436</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.

reconciliation to U.S. GAAP. Certain of the amendments may also affect issuers that rely on Regulation A and investment companies that must comply with the requirements of Regulation S-X. Based on staff analysis of EDGAR filings, we estimate that during calendar year 2019 there were 106 issuers with newly qualified Regulation A offering statements.

The “significant subsidiary” definition in Rule 1-02(w) is applied when determining if a subsidiary is deemed significant for the purposes of certain Regulation S-X and Regulation S-K requirements as well as certain Securities Act and Exchange Act rules and forms.<sup>437</sup> Because the significance of a subsidiary affects the disclosure required from registrants about the activities of those subsidiaries, the amendments we are adopting to Rule 1-02(w) will affect registrants’ significance determinations and, as a result of those determinations, registrants’ disclosure requirements.

Additionally, 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>438</sup> the rules we are amending are relevant to a large number of transactions and businesses but the amendments themselves, beyond their potential cost savings, are not expected to have a significant effect on transactions or businesses more generally. Registrants would be potentially affected by the amendments if they engage in an acquisition or disposition transaction (or series of transactions)

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<sup>437</sup> See *supra* Section II.A.

<sup>438</sup> See Anant K. Sundaram, *Mergers and Acquisitions and Corporate Governance*, 3 MERGERS AND ACQUISITIONS 193 (2004); and 2019 J.P. Morgan Global M&A Outlook, available at <https://www.jpmorgan.com/jmpdf/1320746694177.pdf>.

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, Commission staff searched various form types filed from January 1, 2017 to October 1, 2018 for indications of acquisition or disposition disclosure and found approximately 1,261 filings on various forms that included Rule 3-05 Financial Statements or Rule 3-14 Financial Statements.<sup>439</sup> To better understand the overall market activity for mergers and acquisitions, we also examined mergers and acquisitions data from Thomson Reuters’ Security Data Company (“SDC”). During the period from January 1, 2017 to December 31, 2019, there were 6,057 mergers and acquisitions entered into by publicly-listed U.S. firms. Among these transactions, 1,283 acquisitions involved non-U.S. targets and approximately 419 involved real estate operations.<sup>440</sup> Additionally, 171 of the 6,057 transactions were conducted by entities identified as 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

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<sup>439</sup> Based on a review of Forms 10, S-1, S-3, F-1, F-3, and 8-K. *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>440</sup> We estimate the number of real estate operation transactions that may be within the scope of Rule 3-14 based on transactions covered by SDC where the acquiree uses the Standard Industry Classification code (SIC) 6798 or SIC codes in the 6500s. These SIC codes include real estate companies and REITs generally. The transactions identified using these SIC codes would include, but are not necessarily limited to, real estate operations that are within the scope of Rule 3-14.

the related requirements for smaller reporting companies,<sup>441</sup> as many of these transactions may have involved acquisitions that are small relative to the size of the registrant.<sup>442</sup>

All registered investment companies and business development companies that make fund acquisitions significant enough to trigger Rule 3-05 disclosure requirements would potentially be affected by the amendments. Among registered investment companies, as of the end of calendar year 2019, there were 10,239 open-end funds, 2,050 exchange-traded funds, and 681 closed-end funds. In addition, there were 102 business development companies. While we are not able to observe the universe of the fund acquisitions, 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 three-year period ended December 31, 2019 for indications of fund acquisition disclosure. Among the 503 filings on Form N-14 for fund transactions, 323 filings or 64 percent 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.<sup>443</sup>

### **C. Potential Benefits and Costs of the Final Rule**

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<sup>441</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>442</sup> See Ronald W. Masulis, Cong Wang, & Fei Xie, *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851 (2007) (reporting that the mean (median) relative size of the mergers in their sample is around 16 percent (6 percent) 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.

<sup>443</sup> See *infra* Section V.B.2, Table 5.

## 1. Potential Benefits

We anticipate the amendments<sup>444</sup> will improve the application of the significance tests and assist registrants in making more meaningful significance determinations. We additionally anticipate the amendments will 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.

As they relate to significance determinations generally, the amendments are expected to reduce the burden of determining significance by improving the application of the definition. The amendments also should improve the salience of information for investors by focusing the applicable disclosures on significant subsidiaries.

As they relate to acquisitions and dispositions, the amendments are expected to increase the utility of related disclosures to investors by making these disclosures more relevant. The 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.

The amendments may also permit more timely access to capital. A registrant's ability to provide disclosure for periods prior to an acquisition is often dependent on access to and the cooperation of both the acquired or to be acquired business and its independent auditor. The age

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<sup>444</sup> See *supra* Sections II.A through II.E.

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, can impair a registrant's ability to timely meet the financial reporting requirements for such acquisitions, which may impact its ability to access capital within the time frames 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 amendments should help to ameliorate these impediments, as we discuss in more detail below.

Further, to the extent that the amendments reduce the compliance burden, they may reduce the cost of merger, acquisition, and disposition activity generally. We note that well-functioning markets for corporate control are, on average, generally believed to be beneficial to investors to the extent that they serve as a disciplinary mechanism in which less efficiently managed assets are transferred to more efficient management.<sup>445</sup> It also has been generally observed that mergers and acquisitions may also generate synergies by combining two entities, and may result in firms with more efficient scale or scope.<sup>446</sup>

## **2. Potential Costs**

We do not expect the amendments to generate significant costs for registrants. However, in certain situations the amendments could cause some transactions to be significant that would not be deemed so under the current rules. Inclusion of, for example, additional Rule 3-05

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<sup>445</sup> See, e.g., Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372 (1990) ("Mitchell & Lehn (1990)"); Anup Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, 38 J. FIN. & QUANTITATIVE ANALYSIS 721 (2003) ("Agrawal & Jaffe (2003)").

<sup>446</sup> See, e.g., Li (2013), *supra* note 427 (showing, based on plant-level data, that acquirers increase target's productivity through more efficient use of capital and labor, thus enhancing the value of the acquisitions).

Financial Statements will result in increased costs to such registrants, though this may result in benefits to investors in the form of additional financial disclosures related to the transaction.

We do not anticipate significant costs to investors associated with the amendments. One commenter disagreed with our assessment of the potential costs to investors.<sup>447</sup> According to the commenter, our analysis ignored the potential costs of mergers, manifested in the destruction of value that mergers can cause for the shareholders of the acquiring companies. We acknowledge that there are a significant number of acquisitions that prove to be value-decreasing for the acquirer.<sup>448</sup> However, as discussed above, the amendments are unlikely to affect whether a registrant engages in an acquisition or disposition or whether, with the passage of time, any particular transaction proves to be value-enhancing. More specifically, focusing on any disclosures that could potentially be affected by the amendments, it is clear that various other factors are substantially more likely to affect acquisition and disposition decisions such as, for example, the registrant's assessment of the impact of the acquisition or disposition on its post-

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<sup>447</sup> See letter from CII (generally asserting that disclosures should allow investors to evaluate transactions, including identifying value-decreasing acquisitions, and that recent studies on merger activity find generally negative results of merger activity). We acknowledge that there are varying views regarding the costs and benefits of acquisitions, dispositions, and mergers and we discuss in more detail below the topic of whether particular types of transactions have in general been more value-enhancing or value-decreasing. We also note: (1) our conclusion that, for various reasons, the amendments are highly unlikely to affect whether a transaction proceeds or not, and (2) it is not the role of the Commission to substitute its judgment for that of issuers, shareholders, and other stakeholders regarding an acquisition or disposition transaction. Rather, the Commission's role is to craft rules designed to ensure that investors receive disclosure of information regarding the transaction that is material to an investment decision.

<sup>448</sup> We note that most of the studies that document value-decreasing acquisitions use data on acquisitions of targets that were Exchange Act registered companies. For those targets, the final amendments will not reduce the amount of relevant information available. We also acknowledge that the amendments might affect acquiring firms that acquire private targets more than those that acquire public targets, as financial information of public targets is readily available, regardless of whether Rule 3-05 Financial Statements are required. Prior studies, however, have shown that the acquisitions of private targets on average create shareholder value. See, e.g., Kathleen Fuller, Jeffrey Netter, & Mike Stegemoller, *What Do Returns to Acquiring Firms Tell Us? Evidence from Firms that Make Many Acquisitions*, 57 J. FIN. 1763 (2002) ("Fuller et al. (2002)") (finding that acquisitions of private targets are associated with higher acquirer returns). We acknowledge that investors might face some search costs as target financial information will no longer be disclosed in connection with acquisitions. However, given the current data-gathering capabilities, and the fact that such disclosures will be available on EDGAR in electronic format, we do not expect these costs to be unduly burdensome for investors.

transaction performance. Specifically, other factors that are likely to be substantially more significant to post-transaction performance, and therefore influence decision making regarding the transaction and post-transaction performance, include but are not limited to financing costs, integration costs, ability to achieve expected synergies in the amounts and in the time frames anticipated, whether known and anticipated trends continue and materialize, whether management performs as expected, and whether the resulting actions of competitors, suppliers, distributors, customers and others are consistent with expectations at the time of the transaction. In this regard, we note that one of the recent studies cited by the commenter finds that the main predictors of post-acquisition underperformance are the method of payment (cash versus stock), the acquirer's pre-acquisition asset growth, and the acquirer's excess cash on the balance sheet.<sup>449</sup> Disclosure of these items will be unaffected by the final amendments. We note that, except in circumstances specifically authorized or required by statute, it is not the role of the Commission to substitute its judgment for that of issuers, shareholders, other relevant regulatory authorities and other stakeholders regarding, or otherwise exercise influence over, an acquisition or disposition transaction. Rather, the Commission's role generally, and in particular in this instance, is to craft rules designed to ensure that investors receive disclosure of information regarding the transaction that is material to an investment decision.

We also acknowledge that one objective of the amendments is to reduce unnecessary disclosure and as a result, in some cases, the amendments will reduce the amount of information provided. However, we do not believe that there will be a reduction in the disclosure of information that is material to investors. We anticipate that the amendments will generally result

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<sup>449</sup> See Richard Tortoriello et al., *Mergers & Acquisitions: The Good, the Bad, and the Ugly (and How to Tell Them Apart)*, S&P GLOBAL, Aug. 2016, at 2-4, <https://www.spglobal.com/marketintelligence/en/documents/mergers-and-acquisitions-the-good-the-bad-and-the-ugly-august-2016.pdf>.

in disclosure that is more salient and that any potential loss of information will be mitigated by a registrant's obligation under Rule 4-01(a) of 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. We also note that the disclosures of a registrant's own financial statements are not affected by the rule amendments.

Below we discuss the anticipated economic benefits and costs of specific aspects of the amendments in further detail.

## **D. Economic Effects of Specific Amendments**

### **1. Significance Tests**

The amendments to the significance tests should facilitate registrants' application of the tests. The amendments are expected to bring the Investment Test more in line with the economics of the registrant's interest in a subsidiary or of the transaction for an acquired business, and reduce anomalous results from the Income Test. This, in turn, should reduce compliance burdens associated with the application of the significance tests. In addition, these amendments should facilitate compliance with the application of these tests under Rule 3-05 or Rule 3-14.

The amendments to the Investment Test requiring use of the registrant's aggregate worldwide market value rather than the historical book value of its total assets to assess the significance of acquisitions and dispositions may better reflect the relative size of the business in economic terms. The investments 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>450</sup>

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<sup>450</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. See Tim Koller, Marc Goedhart, & David Wessels, *Valuation: Measuring and Managing the Value of Companies* (7th ed. 2020).

Similarly, using the aggregate worldwide 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 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 for acquisitions and dispositions, the amendments potentially will avoid classifying transactions as significant when they are actually relatively insignificant in economic substance to the registrant. Further, aggregate worldwide 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>451</sup>

The use of aggregate worldwide market value 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>452</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 changes to the Investment Test that we are adopting might introduce errors or bias into the determination of the significance of an acquisition.

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<sup>451</sup> See, e.g., Andrei Shleifer & Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 J. FIN. ECON. 295 (2003) ("Shleifer & Vishny (2003)").

<sup>452</sup> See, e.g., Paul J. Halpern, *Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers*, 46 J. BUS. 554 (1973); Gershon Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. FIN. ECON. 303 (1974) ("Mandelker (1974)").

In response to concerns raised by commenters, the amendments to the Investment Test will require registrants to use the average of aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition. Using the average aggregate worldwide market value should reduce the risk of anomalous results under the Investment Test as a result of market value fluctuations due to other news or events that are unrelated to the acquisitions or dispositions. Thus, we believe the use of the average market value of equity in the Investment Test should better identify the significance of the transaction while avoiding confounding events.

Under the amended Investment Test, some acquisitions may be considered insignificant that would otherwise have been significant under the existing rule. For example, this may occur when an acquiring company's equity is highly-valued, or an acquiring company has a high market-to-book ratio. Studies have shown that companies are more likely to make an acquisition if their stock is overvalued.<sup>453</sup> Therefore, because it uses the aggregate worldwide market value of equity as the denominator, the amended Investment Test may be less likely to require Rule 3-05 or Rule 3-14 Financial Statements for some acquisitions where the acquirer's stock is overvalued.

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<sup>453</sup> See, e.g., Shleifer & Vishny (2003), *supra* note 451, which develops a model showing that over-valued firms are more likely to make an acquisition of undervalued firms using their over-valued stocks. See also Matthew Rhodes-Kropf, David T. Robinson, & S. Viswanathan, *Valuation Waves and Merger Activity: The Empirical Evidence*, 77 J. FIN. ECON. 561 (2005) ("Rhodes-Kropf et al. (2005)"); Ming Dong et al., *Does Investor Misvaluation Drive the Takeover Market?*, 61 J. FIN. 725 (2006) ("Dong et al. (2006)"); James S. Ang & Yingmei Cheng, *Direct Evidence on the Market-Driven Acquisition Theory*, 29 J. FIN. RES. 199 (2006) ("Ang & Cheng (2006)"). All three papers document stock market-driven acquisitions in which acquiring firms acquire targets using their over-valued stocks.

One commenter asserted that the proposed change to the Investment Test would result in less disclosure about acquisitions by companies whose market value is significantly larger than their book value.<sup>454</sup> The potential loss of information may be mitigated because significance is established if any one of the three significance tests is satisfied and Rule 3-05 Financial Statements can also be triggered by the Asset Test or the Income Test.

The amendments to the Income Test adding a revenue component should improve the application of the Income Test by mitigating the effect of infrequent expenses, gains, and losses on the calculation and also potentially preventing insignificant subsidiaries or acquired businesses from being deemed significant for registrants with net income or loss near zero. The amended rules will continue to use income from continuing operations before income taxes for the Income Test rather than after income taxes as proposed, which should also better reflect the significance of a tested subsidiary or acquired business by avoiding distortions that can occur as a result of the tax status of the entity or the volatility of income taxes. Also, as mentioned above, the amendments might affect acquiring firms that acquire private targets more than those that acquire public targets, as financial information of public targets is readily available, regardless of whether Rule 3-05 Financial Statements are required. Prior studies, however, have shown that the acquisitions of private targets on average create shareholder value, which further mitigates the commenter's concerns.<sup>455</sup> The amendments also clarify the application of the proposed revenue component by removing the reference to "recurring annual revenue" and indicating that the revenue component does not apply if either the registrant and its subsidiaries consolidated or

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<sup>454</sup> See letter from CII (asserting that such companies are more likely to use stock as a payment method, which is also a predictor of post-acquisition underperformance).

<sup>455</sup> See, e.g., Fuller et al. (2002), *supra* note 448 (finding that acquisitions of private targets are associated with higher acquirer returns).

the tested subsidiary did not have material revenue in each of the two most recently completed fiscal years. We believe this clarification will aid registrants in applying the test.

The 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 material revenue in each of the two most recently completed fiscal years, the amended Income Test would require both the new revenue component and the net income component to be met.<sup>456</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.

Any potential risks of under-identification as a result of the amendments may be mitigated, because significance is established if any one of the three significance tests are satisfied. Therefore, any under-identification that may result from application of one test may not necessarily impact the outcome of whether disclosure would be required. For example, acquisitions conducted by highly-valued firms might not trigger Rule 3-05 Financial Statements based on the Investment Test because of their higher aggregate worldwide market value of equity. However, Rule 3-05 Financial Statements might still be required based on the Income Test or the Asset Test, thus mitigating the risks of under-identification of economically significant transactions. Additionally, any potential risks of under-identification could be mitigated by the fact that registrants must otherwise disclose material information about the acquisition that is necessary to make the required statements not misleading.

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<sup>456</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* Rule 3-05(b)(2) of Regulation S-X.

Overall, the amendments to the Investment Test and Income Test are expected to better capture the significance of a tested subsidiary or acquired business relative to the registrant, resulting in more salient disclosure and reducing compliance burdens. For example, to the extent that the amendments 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 amendments to the significance tests capture more significant businesses and acquisitions and fewer insignificant ones, they may directly benefit investors by improving the overall salience of the information disclosed to them. Investors may also indirectly benefit from the amendments 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.

We believe that overall the amendments 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 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 believe the benefits from the reduction in

disclosure burden and audit costs 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 amendments would be approximately 125 hours per Rule 3-05 Financial Statement filing.<sup>457</sup> In addition to these compliance cost savings, there could be other and more substantial benefits from the amendments. The amendments could facilitate merger and acquisition transactions and facilitate an acquiring company's access to capital. 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 impede its capital raising efforts.

The impact of the 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.

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<sup>457</sup> See *infra* Section V.B.1, Table 1.

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

The 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 consummation of acquisitions. 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, segment, or division, such as a product line or a line of business contained in more than one subsidiary of the selling entity. 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. As a result, a registrant may be unable to provide the financial statements required under the current rule. In these circumstances, the amendments provide that registrants would be permitted to file abbreviated financial statements to comply with Rule 3-05 if the total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20 percent or less of such corresponding amounts of the seller and its subsidiaries consolidated. This bright line threshold is a modification from the proposal in response to commenter feedback. Applying a 20 percent bright line threshold will reduce inconsistency in interpreting "small portion of the selling entity" and should facilitate compliance by registrants. A bright line threshold in the disclosure requirement may lead to over- or under-identification. However, a 20 percent threshold also is generally consistent with the staff's granting of relief pursuant to Rule 3-13 in such situations. This amendment also will help ensure that abbreviated financial statements are not used when the component of the selling entity acquired is sufficiently large such that presentation of the seller's financial statements, along with pro forma financial information that removes the portion of the seller not acquired, would best inform investors about the business acquired. Additionally, we are clarifying the

meaning of the term “segment,” the description of expenses, and the presentation of the abbreviated financial statements. These clarifications should improve registrant’s ability to comply with the Rule 3-05 disclosure requirements. We believe allowing for abbreviated financial statements in these circumstances will reduce costs for registrants and facilitate the consummation of acquisitions. We also believe any potential costs to investors as a result of decreases in disclosure will be mitigated by the fact that registrants must otherwise disclose material information about the acquisition that is necessary to make the required statements not misleading.

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

When an acquired or to be acquired oil and gas producing business represents a component of an entity that does not constitute a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable), 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 or to be acquired business on the registrant, the amendments would permit registrants to provide abbreviated financial statements that consist of income statements modified to exclude expenses not comparable to future operations. We believe allowing for abbreviated financial statements in these circumstances will reduce costs for registrants. As noted above, we believe any potential costs to investors as a result of decreases in disclosure will be mitigated by the fact that registrants must otherwise disclose material information about the acquisition that is necessary to make the required statements not misleading.

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

The amendments include several revisions that clarify the timing and terminology related to the disclosure requirements, with some revisions based on commenter feedback. 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 these amendments do not modify the information required to be disclosed, we do not believe investors would be negatively affected by them. To the extent that these amendments make compliance more efficient for registrants, investors may indirectly benefit as cost savings could be passed through to them.

## **6. Foreign Businesses**

The amendments 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 a comprehensive basis of accounting principles other than U.S. GAAP or IFRS-IASB to be reconciled to IFRS-IASB rather than U.S. GAAP for an acquired business that is a foreign business (as defined in 17 CFR 210.1-02(*l*)). Permitting the 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.

The amendments also allow Rule 3-05 and Rule 3-14 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP for an acquired business that is not a foreign business (as defined in 17 CFR 210.1-02(*l*)), but would qualify as a foreign private issuer if it were a registrant. Preparing financial statements without reconciliation to U.S. GAAP in these circumstances reduces the compliance costs where an acquired business in a

cross-border acquisition does not have U.S. GAAP financial statements. It may also reduce transaction costs associated with acquiring 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.

The amendments further permit an acquired business that is not a foreign business, but would qualify as a foreign private issuer if it were a registrant to reconcile its financial statements prepared according to a comprehensive basis of accounting principles other than U.S. GAAP or IFRS-IASB to IFRS-IASB rather than U.S. GAAP when the registrant is a foreign private issuer that uses IFRS-IASB. 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 more comparable information, which could be more expeditiously analyzed. The amendments further clarify that this reconciliation should generally follow the form and content requirements in Item 17(c) of Form 20-F; however, accommodations in Item 17(c)(2) of Form 20-F that would be inconsistent with IFRS-IASB will not be available, and IFRS 1, *First-time Adoption of International Financial Reporting Standards*, may be applied. The improved clarity in the amendment should improve registrants' compliance process, potentially reducing compliance costs.

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 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 percent of acquisitions by U.S. companies involved non-U.S. targets. To the extent that the 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>458</sup>

A possible consequence from the amendments could 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>459</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 do not expect the amendments to impose substantial costs on investors because they should be familiar with IFRS-IASB financial statements from other contexts. Specifically, foreign private issuers have been permitted to file IFRS-IASB financial statements without reconciliation to U.S. GAAP for some time,<sup>460</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 will necessarily lower the disclosure standard or cause undue confusion. In addition, pro 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.

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<sup>458</sup> See, e.g., Kenneth R. Ahern, Daniele Daminelli, & Cesare Fracassi, *Lost in Translation? The Effect of Cultural Values on Mergers Around the World*, 117 J. FIN. ECON. 165 (2015).

<sup>459</sup> As an example, IFRS-IASB permits the recognition of internally generated intangible assets in limited circumstances; U.S. GAAP does not.

<sup>460</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 (Jan. 4, 2008)].

GAAP, which should mitigate any potential inconsistencies in the pre-acquisition historical financial statements.

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

The amendments 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 amendments to Rule 8-04 also apply to issuers relying on Regulation A. Since the form and content of the required financial statements will continue to be prepared in accordance with Article 8, we do not believe the amendments will impose additional compliance costs on affected entities and do not expect the amendments to reduce information available to investors.

The 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 could 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>461</sup> As a result, we do not expect that the amendments will impose significant new costs on these entities. At the same time, the amendments may provide more relevant information to investors, although this benefit also will be limited to the extent that smaller reporting companies already comply with these requirements in practice.

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<sup>461</sup> See *supra* note 346.

The amendments do not provide additional accommodation for smaller reporting companies as suggested by some commenters.<sup>462</sup> As discussed in Section II.A.7.c above, additional accommodations might potentially complicate application of the rule. However, we expect the amendments will ease compliance burdens and simplify the application of our rules for all affected entities. To the extent that these compliance burdens entail certain fixed costs that do not scale with the size of the acquirer, smaller reporting companies and issuers relying on Regulation A may particularly benefit from the adopted changes.

**8. 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 amendments allow registrants to omit Rule 3-05 and Rule 3-14 Financial Statements from Securities Act registration statements and proxy statements for businesses that exceed 20 percent, but do not exceed 40 percent, significance after inclusion in post-acquisition results for nine months (rather than the proposed complete fiscal year) and for businesses that exceed 40 percent significance once they are included in the registrant’s post-acquisition results for a complete fiscal year. These amendments provide consistency between Rule 3-06 and Rule 3-05 for acquisitions that exceed 20 percent, but do not exceed 40 percent significance, and could also improve 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. These modifications are in response to commenter feedback. We anticipate reduced compliance burdens on registrants and do not anticipate significant costs on investors. We expect the amendments to be especially useful for registrants

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<sup>462</sup> See *supra* Section II.A.7.

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 will still receive disclosure about material effects of the acquisition through the registrant's management's discussion and analysis.<sup>463</sup> We therefore do not expect the 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.

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

The amendments permit the use of pro forma financial information to measure significance in initial registration statements. The amendments further clarify, based on commenter input, that if a registrant uses pro forma financial information to measure significance, it must continue to use pro forma financial information to measure significance until the next annual report on Form 10-K. 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

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<sup>463</sup> See 17 CFR 229.303.

formation. Because pro forma financial information may capture the effects of significant acquisitions and dispositions consummated after the latest fiscal year-end that are not reflected in the registrant’s annual 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 amendments could potentially reduce the amount of information presented to investors if significance determinations on the basis of pro forma financial 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 mitigate concerns about any loss of relevant information to investors.

#### **10. 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 percent.<sup>464</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>465</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

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<sup>464</sup> See *supra* note 201.

<sup>465</sup> See *supra* note 211.

forma financial information that might not reflect the aggregate effect of the “individually insignificant businesses.”

The amendments will affect disclosure requirements for individually insignificant businesses in several ways. First, the amendments require the registrants to provide audited historical financial statements only for those acquired businesses whose individual significance exceeds 20 percent. Reducing required disclosure of audited historical financial statements for insignificant acquisitions could improve registrants’ access to capital since preparing such disclosure 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 amendments may make it easier, quicker, and cheaper for registrants to access capital. The amendments also reduce registrants’ disclosure burdens, leading to cost savings that may ultimately benefit shareholders.

Second, the 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 amendments.

The amendments might impose additional compliance burdens on registrants to the extent they are required 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 will be subject to this 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. The amendments also expand the aggregate impact determination to include both Rule 3-05 and Rule 3-14 acquisitions. This modification is consistent with the objective of aligning Rule 3-14 with Rule 3-05. We do not believe there will be significant economic effects from this expansion as the modification will apply only to registrants that acquire both Rule 3-05 businesses and Rule 3-14 real estate operations.

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

The amendments align Rule 3-14 with Rule 3-05 where no unique industry considerations warrant differentiated treatment of real estate operations. For example, the amendments align the threshold for individual significance for both rules at “exceeds 20 percent” and the threshold for aggregate significance for both rules at “exceeds 50 percent.” The amendments also align Rule 3-14 with 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 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 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 amendments 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 significance provisions for blind pool offerings that are consistent with current practice. Thus, while these amendments may reduce potential compliance uncertainty and ambiguity for registrants, we do not expect them to have a substantial effect on current disclosure practices.

In addition, because the special significance provisions for “blind pool offerings” are based on the unique characteristics of the offering and the registrant, rather than the type of acquisitions, the amendments also extend these special significance provisions to business acquisitions subject to Rule 3-05 by registrants conducting “blind pool” offerings. We do not believe this extension will have significant economic effects as the extended accommodation will only affect a very small population of registrants. For those it does impact, the amendment will increase consistency in the application of Rules 3-14 and 3-05, thereby reducing costs of preparation for registrants and immaterial disclosure to investors.

## **12. Pro Forma Financial Information**

The amendments to replace the existing pro forma adjustment criteria in Article 11 of Regulation S-X with Transaction Accounting Adjustments and Autonomous Entity Adjustments simplify these requirements and reduce potential inconsistency in preparing pro forma financial information. The amendments to Article 11 could benefit investors in several ways. First, the 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 Transaction Accounting Adjustments may permit registrants to better reflect acquisitions, dispositions, or other transactions, which could help investors better understand the effects of these transactions on the registrant’s audited historical financial statements. Altogether, the

amendments are expected to improve the relevance of the information disclosed to investors and help investors process information more effectively.

In a change from the proposal, under the final amendments, Management's Adjustments depicting synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given may, in the registrant's discretion, be presented if in its management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and specified conditions related to the *Basis for Management's Adjustments* and the *Form of Presentation* are met.<sup>466</sup> On the one hand, Management's Adjustments may provide investors better insight into the potential effects of the transaction as contemplated by the company. This potentially benefits investors by helping them to distinguish the accounting effects of the acquisitions or dispositions from management's judgment as to the expected operational effects based on management plans. On the other hand, there may be different levels of confidence about forward-looking information related to different types of synergies and dis-synergies contemplated by management. Making Management's Adjustments optional benefits registrants by permitting them to avoid uncertainties of estimation and increase flexibility in compliance, thus potentially reducing compliance costs.

The amendments to Article 11 could impose costs on registrants because they would be required to meet new presentation requirements for required or optional 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>467</sup> However, synergy and dis-synergy estimation by registrants may introduce certain subjective judgments into the pro forma

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<sup>466</sup> See *supra* Section II.D.1.c.

<sup>467</sup> See *infra* Section V.B.1, Table 1.

financial statements, potentially making them more difficult for investors to interpret. In addition, making Management's Adjustments optional could create risk that such adjustments would be disclosed selectively. The requirement that registrants disclose uncertainties, assumptions, and calculation methods and the requirement that when synergies are presented, any related dis-synergies must also be presented along with the Management's Adjustments, could mitigate the risk of biased pro forma adjustments. The amendments appear unlikely to cause significant loss in information for investors regarding the effects of the transaction; indeed investors may gain important insights to the extent a registrant chooses to disclose Management's Adjustments.

### **13. Significance and Business Dispositions**

The amendments to conform the significance tests for a disposed business to that of an acquired business and to increase the threshold for determining the significance of a business disposition from 10 percent to 20 percent will reduce inconsistencies in reporting between acquisitions and dispositions and potentially reduce registrants' compliance burden.<sup>468</sup> For example, under the amendments, registrants will not have to file pro forma financial information for insignificant dispositions (*e.g.*, dispositions with significance levels exceeding 10 percent but not 20 percent), 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 transactions. For example, a registrant might engage in both acquisitions and dispositions during the same reporting period. Identical thresholds might help achieve internal consistency in

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<sup>468</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 percent significance threshold, not the 20 percent threshold used for business acquisitions under Rules 3-05 and 11-01(b).

financial reporting in evaluating the impact of both types of transactions as well as the net effects. For investors, the 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.

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

We believe the amendments related to investment companies would reduce compliance burdens by streamlining the disclosure requirements in a way that is tailored to investment companies. We do not anticipate significant costs to investors related to the amendments, because we do not believe the amendments will result in a reduction in 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>469</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.

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<sup>469</sup> Investment income includes dividends, 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.

The amendments include a separate definition of “significant subsidiary” and separate significance tests specifically tailored for investment companies. The amendments focus the significance determination for investment companies on the impact to the registrant’s investment portfolio held by the registrant. Further, the amended significance tests 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 amendments will benefit both investment companies and their investors by providing more appropriate standards for determining the significance of fund acquisitions. For example, the amended Income Test better aligns income from a particular investment or acquisition for purposes of analyzing the effect on the income of the investment company as a whole. We thus expect the amended 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. The amendments also permit the use of a five-year average for income if income for the past year is at least 10 percent less than the average income for the past five years. The amendments also revise the calculation of income to be the absolute value of “the sum” of 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. These modifications were made to prevent confusion in applying absolute value with respect to income and avoid the potential double counting of gains or losses. As a result, the amendments may more accurately identify acquisitions that are economically significant to investment company registrants. This will benefit registrants as they will not be required to prepare separate

financial disclosure for economically insignificant acquisitions. The amendments also may benefit investors by avoiding the need to focus on economically insignificant acquisitions that are deemed significant under current rules. Furthermore, we do not anticipate that the amended significance tests would impose substantial costs on registrants to implement because we believe the required measures should be readily available to registrants.

The amended significance thresholds for the Income Test in Rule 1-02(w) when applied to investment companies has two prongs: either (i) a threshold of 80 percent for income alone or (ii) a 10 percent threshold together with an Investment Test result higher than 5 percent. This amended threshold might reduce the compliance burden faced by investment companies as there is 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 amendments potentially better identify fund acquisitions that warrant additional disclosure. This amendment 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 amendment to eliminate an asset-based test for investment companies simplifies 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, is largely superfluous in light of the amended Investment Test for investment companies. 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.

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. Rule 6-11 deems 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 under-reporting of acquired fund disclosures by focusing on the economic substance of the transaction rather than its legal form. The amendments to require one year of audited financial statements for fund acquisitions and to eliminate pro forma financial statements could also reduce compliance burdens for registrants. We do not believe these amendments will 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 amendments are also consistent with the accommodations typically provided by our disclosure review staff during consultations.<sup>470</sup> Permitting investment companies to provide financial statements for private funds that were prepared in accordance with U.S. GAAP will 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 will

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<sup>470</sup> See *supra* note 58.

be mitigated by the requirement that investment companies file the schedules required under Article 12 of Regulation S-X and provide certain supplemental information regarding the acquired funds. We believe this information is more relevant and potentially enhances efficiency in processing the information by fund investors. These supplemental disclosures, however, will entail costs to registrants. For purposes of the PRA, we estimate the average incremental compliance burden for this additional disclosure is around 25 hours per affected registrant. We further estimate that all of these amendments taken together will reduce a registrant's compliance burden by approximately 100 hours.<sup>471</sup>

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

We anticipate that the amendments will have favorable effects on efficiency, competition, and capital formation for both operating companies and investment companies. By reducing disclosure burdens for registrants regarding business acquisitions and dispositions, the amendments should facilitate such activities, although, as stated earlier, compliance costs may be a more modest factor when a registrant considers whether to engage in an acquisition or disposition. An active mergers and acquisitions market creates efficiencies by transferring inefficiently managed assets to more efficient management or by creating synergies through

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<sup>471</sup> See *infra* Section V.B.2.

economies of scale or economies of scope.<sup>472</sup> On average, mergers and acquisitions benefit investors in the acquired business.<sup>473</sup>

The amendments to revise the disclosure relating to acquired and disposed businesses are expected to 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 amendments is about 82,225 company hours.<sup>474</sup> The resulting total reduction in incremental professional costs for all forms under the amendments is approximately \$21,470,000.<sup>475</sup> We thus believe the potential cost savings from the amendments are significant.

At the same time, we do not believe investors face a significant loss in information as a result of the amendments. Instead, we expect the amendments to 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 increased efficiency in the market for mergers and acquisitions. Under the existing disclosure requirements related to acquired

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<sup>472</sup> For a discussion of the benefits of the market for corporate control, *see, e.g.*, Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 *Journal of Financial Economics* 5 (1983) (“Jensen & Ruback (1983)”) (noting that an active takeover market can create efficiencies by transferring inefficiently managed assets to more efficient management—or by creating synergies through economies of scale or scope). For a discussion of the agency costs of mergers and acquisitions, *see, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *Journal of Financial Economics*, 305 (1976) (explaining that managers have private incentives to conduct mergers and acquisitions to increase the size of the firm in order to extract more pay or perquisites at shareholder expense).

<sup>473</sup> Empirical studies have shown that around M&A announcements, the target firms earn a significant abnormal return. *See, e.g.*, Mandelker (1974), *supra* note 452; Jensen & Ruback (1983), *supra* note 472; Joy Ishii & Yuhai Xuan, *Acquirer-Target Social Ties and Merger Outcomes*, 112 *J. FIN. ECON.* 344 (2014).

<sup>474</sup> *See infra* Section V.C, Table 5 Column E.

<sup>475</sup> *See infra* Section V.C, Table 5 Column F.

businesses, some mergers may be delayed or more costly due to the burdens 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 disclosure because the business crosses the highest significance threshold). By decreasing the acquisition costs for registrants, the amendments 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 could help achieve efficient capital allocation and exert effective external control mechanisms on public firms, leading to an overall increase in efficiency.<sup>476</sup>

## **F. Alternatives Considered**

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

One alternative to the amended 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 disposed 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-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

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<sup>476</sup> Studies have found that mergers may create shareholder value when the assets are transferred from inefficient management to more efficient management. *See* Mitchell & Lehn (1990), *supra* note 427; Agrawal & Jaffe (2003), *supra* note 427; Kenneth M. Lehn & Mengxin Zhao, *CEO Turnovers after Acquisitions: Are Bad Bidders Fired?*, 61 J. FIN. 1759 (2006).

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 about what level of disclosure is required in an environment where delay is costly. Also, where a registrant misjudges materiality and fails 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. As a result, 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 significant to a registrant.

The Investment Test compares the registrant's and its other subsidiaries' investments in and advances to the acquired business against the carrying value of the registrant's total assets. The amendment to the Investment Test uses the aggregate worldwide market value of the registrant's voting and non-voting common equity calculated as the average of such aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed fiscal quarter ending prior to the earlier of the registrant's announcement date

or agreement date of the acquisition or disposition. As an alternative to the amended Investment Test, we could have required registrants to use enterprise value for the acquirer and the acquired business, rather than the value of common equity (for the acquirer) and investments 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 amendment 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 approach to the Investment Test, which requires measurement of investments in an acquisition against the acquirer's aggregate worldwide market value, averaged over the last five trading days of the registrant's most recently completed fiscal quarter ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition, might not reflect all information about the value of the acquirer. As an

alternative, we could have required the registrant to use its average market value over a longer period of time rather than a five trading day window 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 over a longer period could increase complexity 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).

With respect to the Income Test, one alternative 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>477</sup>

A second alternative to the amended 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>477</sup> See *Separate Financial Statements Required by Regulation S-X*, Release No. 33-6359 (Nov. 6, 1981) [46 FR 56171 (Nov. 16, 1981)] (“The 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 amended Income Test, such an alternative may have a lower risk of under-identification of significant transactions if the 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 physical capital. Moreover, for those that rely heavily on tangible assets, the information provided by a return on assets threshold may be subsumed by the existing Asset Test.

A third alternative to the amended 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 adopting Income Test would be to lower the threshold required to meet the revenue component, for example to 15 percent or 10 percent. A potential benefit of this approach is that it may mitigate the risk of under-identification of significant transactions. However, it is 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 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 at the time an acquisition is consummated or probable, which include, among other things, supplemental pro forma information about revenue and earnings for the two years prior to the acquisition. Under this approach, registrants would be 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>478</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 the final amendments, 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 Adopting Pro Forma Adjustments**

An alternative to the optional Management's Adjustments for pro forma financial information is to require the disclosure of Management's Adjustments for synergies and dis-synergies that have occurred after the acquisition date but before filing the pro forma financial information and for forward-looking information previously filed with the Commission. This alternative might provide a more complete depiction of the expected effects of the transaction

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<sup>478</sup> See FASB ASC 805-10-50-1.

and avoid circumstances where Management's Adjustments are selectively presented because they are optional. However, as commenters observed, this alternative could give rise to compliance challenges for registrants as synergies and dis-synergies may not be tracked at the line-item level required in pro forma financial information. Also, requiring quantification of synergies and dis-synergies that have occurred would impose a requirement to create books and records related to synergies and dis-synergies even when they were not a significant factor in the decision to execute the transaction. Moreover, synergies may take more time (*e.g.*, more than a year) to be achieved and estimated; thus, such a requirement might not be practical for certain transactions in certain industries. We therefore decided not to adopt this alternative.

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

One alternative to the amended 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 amended test for registrants without necessarily providing significant incremental benefits to investors.

Another alternative to the amended income test for investment companies would be to select a percentage lower than 80 percent 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 not material (particularly if the income of the acquiring fund is relatively low). The combination of the amended Income Test and Investment Test in the final amendments is intended to mitigate this result.

## **V. Paperwork Reduction Act**

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

Certain provisions of our rules and forms that would be affected by the amendments contain "collection of information" requirements within the meaning of the PRA.<sup>479</sup> The Commission published a notice requesting comment on the collection of information requirements in the Proposing Release, and submitted the proposed amendments to the Office of Management and Budget ("OMB") for review in accordance with the PRA.<sup>480</sup> While several commenters provided comments on the potential costs of the proposed amendments, no commenters specifically addressed our PRA analysis.<sup>481</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

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<sup>479</sup> See 44 U.S.C. 3501 *et seq.*

<sup>480</sup> 44 U.S.C. 3507(d) and 5 CFR 1320.11.

<sup>481</sup> See Section II above.

for the affected collections of information are:<sup>482</sup>

- “Form S-1” (OMB Control No. 3235-0065);
- “Form S-3” (OMB Control No. 3235-0073);
- “Form F-1” (OMB Control No. 3235-0258);
- “Form F-3” (OMB Control No. 3235-0256);
- “Form 10” (OMB Control No. 3235-0064);
- “Form 8-K” (OMB Control No. 3235-0060);
- “Form N-1A” (OMB Control No. 3235-0307);
- “Form N-2” (OMB Control No. 3235-0026);
- “Form N-14” (OMB Control No. 3235-0336); and
- “Form 1-A” (OMB Control No. 3235-0286).

The regulations, schedules, and forms listed above were adopted under the Securities Act, 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. A description of the amendments, including the need for the information and its use as well as a description of the

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<sup>482</sup> A number of forms could require Rule 3-05, Rule 3-14, and other disclosure impacted by the amendments such that the 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 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). For example, staff experience has shown that for filings on Form S-4, registrants most often incorporate Rule 3-05 or Rule 3-14 Financial Statements by reference to a previously filed Form 8-K. While the 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 amendments, we are not adjusting the burden estimates associated with these collections of information.

likely respondents, can be found in Section II above, and a discussion of the economic effects of the amendments can be found in Section IV above.

**B. Effect of the Amendments on Existing Collections of Information**

**1. Estimated Effects on Burdens for Registrants Other Than Investment Companies**

The following table summarizes the estimated effects of the 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 1-02(w), Rule 3-05, Rule 3-14, and related rules	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 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 Statements require an average of 500 burden hours as discussed in note 298 of the Proposing Release.</li> </ul>
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 amendments to the pro forma financial information requirements under Article 11 and Rule 8-05 of Regulation S-X, including the changes that permit registrants to provide certain forward-looking information, when considered in the aggregate and compared to the paperwork burden under existing requirements.</li> </ul>

		<ul style="list-style-type: none"> <li>● For PRA purposes, we estimate that existing pro forma financial information requires an average of 100 burden hours as discussed in note 299 of the Proposing Release.</li> </ul>
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**a. Proposed Amendments to Rules 1-02(w), 3-05, and 3-14**

Considering the various revisions outlined in Sections II.B. and C. above, we estimate that the amendments to Rule 1-02(w), 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.<sup>483</sup> 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 amendments, we estimated the number of filings that include Rule 3-05 and Rule 3-14 Financial Statements, used this data to extrapolate the effect of these changes on the paperwork burden, and applied these percentages to the current estimates for the number of responses in the Commission’s current OMB PRA filing inventory.<sup>484</sup>

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

Considering the various revisions outlined in Section II.D. above, we estimate that the amendments to Article 11 and Rule 8-05 will reduce a registrant’s paperwork burden by simplifying disclosure requirements generally, but may increase burdens to the extent that the registrants are required to depict pro forma financial information for the aggregate impact in all

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<sup>483</sup> The Rule 1-02(w) definition of “significant subsidiary” is used in a number of rules and forms, including Form 20-F, Form S-3, Form F-3, Schedule 14A, Form 8-K, Form 1-U, Form 10-Q, and Form 10-K. *See supra* note 23. We do not expect the changes to the definition to materially affect the burden estimate for these rules and forms beyond the effects for the changes related to Rule 3-05 and Rule 3-14 discussed in this PRA.

<sup>484</sup> To develop these estimates, Commission staff searched and analyzed filings for the calendar year 2017 and the first nine months of 2018. *See* discussion in Section V.B.1.a. of the Proposing Release.

material respects of the acquired businesses, rather than only a mathematical majority of the individually insignificant businesses acquired, and in the case of smaller reporting companies, requiring pro forma financial information in some additional circumstances<sup>485</sup> and requiring that the information be provided in a clearer and more robust manner. We are adopting amendments that permit, rather than require, registrants to include certain forward-looking information in the Management's Adjustments to the pro forma financial information. We have not revised our burden estimates from the Proposing Release as a result of this changes in order to more conservatively estimate the burden on issuers of providing this disclosure because these changes may additionally increase burdens to the extent registrants provide the disclosure. 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 estimates of affected forms that we determined for the Rule 3-05 and Rule 3-14 burden estimates.

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

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

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<sup>485</sup> The additional circumstances that would require a smaller reporting company to present pro forma financial information under the 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.

**Table 2: Estimated Paperwork Burden Effects for Investment Companies**

Amendment	Estimated Effect and Affected Forms	Brief Explanation of Estimated Effect
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 amendments discussed in Section II.E. above<sup>486</sup> compared to existing Rule 3-05 and pro forma financial information requirements.<sup>487</sup></li> <li>● This reduction was then offset by an estimated increase of 25 burden hours for the schedules and supplemental information under Rule 6-11.<sup>488</sup></li> </ul>

Considering the various revisions outlined in Section II.E above, we estimate that Rule 6-11 and the related amendments generally will 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 paperwork burden reduction from the amendments, we estimated the number of filings that include acquired fund financial statements, used this data to extrapolate the effect of these changes on the paperwork burden, and applied these percentages to the current estimates for the number of responses in the Commission’s current OMB PRA filing inventory.<sup>489</sup>

**C. Aggregate Burden and Cost Estimates for the Amendments**

<sup>486</sup> This estimated reduction of 125 burden hours is due to the 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>487</sup> To determine the paperwork burden for a registrant to make disclosures in accordance with Rule 6-11 and 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* Proposing Release at note 298.

<sup>488</sup> *See supra* Section II.E.2 and II.E.3.

<sup>489</sup> *See* discussion in Section V.B.2. of the Proposing Release.

Below we estimate the aggregate change in paperwork burden as a result of the 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 amendments. The portion of the burden carried by outside professionals is reflected as a cost,<sup>490</sup> while the portion of the burden carried by the registrant internally is reflected in hours.<sup>491</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 amendments.

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<sup>490</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>491</sup> For purposes of the PRA, we estimate that 75 percent of the burden of preparation of Forms 8-K and 1-A is carried by the registrant internally and that 25 percent 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 percent 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 percent of the burden of preparation is carried by outside professionals retained by the company at an average cost of \$400 per hour.

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

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 4: Calculation of the Change in Burden Estimates of Current Responses Due to 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 5: Requested Paperwork Burden under the Amendments**

Form	Current Burden			Program Change			Requested Change in Burden		
	Current Annual Responses (A)	Current Burden Hours (B)	Current Professional Cost Burden (C)	Number of Affected Responses (D)	Reduction in Company Hours (E)	Reduction in Professional Costs (F)	Annual Responses (G) = (A)	Burden Hours (H) = (B) + (E)	Professional Cost Burden (I) = (C) + (F)
10	216	11,855	\$14,091,488	20	(500)	(\$600,000)	216	11,355	\$13,491,488
1-A	179	98,396	\$13,111,912	18	(1,350)	(\$180,000)	179	97,046	\$12,931,912
S-1	901	147,208	\$180,319,975	78	(1,950)	(\$2,340,000)	901	145,259	\$177,979,975
S-3	1,657	1963,626	\$236,198,036	192	(4,800)	(\$5,760,000)	1,657	188,825	\$230,438,036
F-1	63	26,692	\$32,275,375	2	(50)	(\$60,000)	63	26,642	\$32,215,375
F-3	112	4,441	\$5,703,600	3	(75)	(\$90,000)	112	4,366	\$5,613,600
8-K	118,387	818,158	\$108,674,430	947	(71,025)	(\$9,470,000)	118,387	747,133	\$99,204,430
N-1A	6,002	1,642,490	\$131,139,208	8	(200)	(\$240,000)	6,002	1,642,290	\$130,899,208
N-2	166	74,145	\$4,718,196	3	(75)	(\$90,000)	166	74,070	\$4,628,196
N-14	253	125,820	\$5,842,000	88	(2,200)	(\$2,640,000)	192	123,620	\$3,202,000

## VI. Final Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (“RFA”)<sup>492</sup> requires the Commission, in promulgating rules under Section 553 of the Administrative Procedure Act,<sup>493</sup> to consider the impact of those rules on small entities. We have prepared this Final Regulatory Flexibility Act Analysis in accordance with Section 604 of the RFA.<sup>494</sup> It relates to the amendments to the definition of “significant subsidiary” and the financial disclosure requirements in Regulation S-X relating to significant business acquisitions and dispositions to improve those requirements for both investors and registrants. An Initial Regulatory Flexibility Analysis (“IRFA”) was prepared in accordance with the RFA and was included in the Proposing Release.

### A. Reasons for, and Objectives of, the Final Amendments

<sup>492</sup> 5 U.S.C. 601 *et seq.*

<sup>493</sup> 5 U.S.C. 553.

<sup>494</sup> 5 U.S.C. 604.

The amendments include changes to the definition of “significant subsidiary”<sup>495</sup> and 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>496</sup> We are also adopting new Rule 6-11 and amendments to Form N-14 to specifically govern financial reporting for acquisitions involving investment companies. The purpose of the amendments is to improve the application of the rules, assist registrants in making more meaningful determinations of whether a subsidiary or an acquired or disposed business is significant, and to improve the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses, including real estate operations and investment companies. The reasons for, and objectives of, the amendments are discussed in more detail in Sections II.A through II.E. above.

#### **B. Significant Issues Raised by Public Comments**

In the Proposing Release, we requested comment on all aspects of the IRFA, including the number of small entities that would be affected by the proposed amendments, the existence or natures of the potential impact of the proposals on small entities discussed in the analysis, and how to quantify the impact of the proposed amendments. We did not receive any comments specifically addressing the IRFA. However, we received a number of comments on the proposed amendments generally,<sup>497</sup> and have considered these comments in developing the FRFA.

#### **C. Small Entities Subject to the Proposed Rules**

The final amendments will affect some registrants that are small entities. The RFA

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<sup>495</sup> We are amending the definition of “significant subsidiary” in Rule 1-02(w) of Regulation S-X, Exchange Act Rule 12b-2, Securities Act Rule 405, and Investment Company Act Rule 8b-2.

<sup>496</sup> We are also amending Rule 3-06 and Rule 3-09, Article 8, and Article 11 of Regulation S-X. In addition, we are making related amendments to Form S-11, Form 1-A, Form 8-K, Form 10-K, and Form N-2.

<sup>497</sup> See Section II above.

defines “small entity” to mean “small business,” “small organization,” or “small governmental jurisdiction.”<sup>498</sup> For purposes of the RFA, 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>499</sup> We estimate that there are 1,056 issuers that file with the Commission, other than investment companies, that may be considered small entities and are potentially subject to the final amendments.<sup>500</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>501</sup> Commission staff estimates that, as of December 31, 2019, there were approximately 76 open-end and closed-end investment companies that would be considered small entities. Commission staff further estimates that, as of December 31, 2019, approximately 14 business development companies were small entities.<sup>502</sup>

#### **D. Reporting, Recordkeeping, and Other Compliance Requirements**

As noted above, the purpose of the final amendments is to improve the application of the rules and reduce the complexity and costs of preparing the related disclosure.<sup>503</sup> We are also amending specific regulatory requirements for investment companies to address the unique

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<sup>498</sup> 5 U.S.C. 601(6).

<sup>499</sup> See 17 CFR 230.157 under the Securities Act and 17 CFR 240.0-10(a) under the Exchange Act.

<sup>500</sup> This estimate is based on staff analysis of issuers, excluding core registrants, with EDGAR filings of Form 10-K, 20-F and 40-F, or amendments thereto, 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>501</sup> 17 CFR 270.0–10(a).

<sup>502</sup> These estimates are based on staff analysis of Morningstar data and data submitted by investment company registrants in forms filed on EDGAR as of December 31, 2019.

<sup>503</sup> See *supra* Sections II.A. through II.D. for a detailed discussion of the final amendments applicable to registrants with operations or that otherwise are not investment companies.

attributes of this group of registrants.<sup>504</sup>

Many of the changes simplify and streamline existing disclosure requirements in ways that are expected to reduce compliance burdens for all registrants, including small entities. Some, such as the rules permitting registrants to include Management's Adjustments in their pro forma financial information, could incrementally increase compliance costs to the extent that an entity chooses to provide this disclosure. In addition, compliance with the final amendments requires the use of professional skills, including accounting and legal skills. We discuss the economic impact, including the estimated costs and burdens, of the final amendments to all registrants, including small entities, in Sections IV and V above.

#### **E. Agency Action to Minimize Effect on Small Entities**

The RFA directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Accordingly, 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 final amendments generally simplify and streamline disclosure requirements in ways that are expected to reduce compliance burdens for all registrants, including small entities.

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<sup>504</sup> See *supra* Section II.E.

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 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>505</sup> For investment companies, we believe that 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 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 final amendments or to establish different compliance or reporting requirements for such entities.

Finally, with respect to using performance rather than design standards, Regulation S-X and the final 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 final 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 allows 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.

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<sup>505</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. Commission staff also found that out of 12 Forms 1-A originally filed in 2019 that disclosed acquisitions subject to Rule 8-04 or Rule 8-06, 9 appeared to comply with Article 11 requirements.

## **VII. Statutory Authority**

The amendments contained in this release are being adopted 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 AMENDMENTS**

For the reasons set out in the preamble, the Commission amends 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. Amend § 210.1-02 by revising paragraph (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 registrant is a registered investment company or a business development company, the tested subsidiary meets any of the conditions in paragraph (w)(2) of this section instead of any of the conditions in paragraph (w)(1) of this section. A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles (U.S. GAAP) must 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) must use amounts determined under IFRS-IASB.

(i) Investment Test.

(A) For acquisitions, other than those described in paragraph (B), and dispositions this test is met when 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.

(1) For acquisitions, the "investments in" the tested subsidiary is the consideration transferred, adjusted to exclude the registrant's and its other 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. It must 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, it must include all contingent consideration, except contingent consideration for which the likelihood of payment is remote.

(2) For dispositions, the "investments in" the tested subsidiary is the fair value of the consideration, including contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant's voting and non-voting common equity, 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.

(3) When determining the aggregate worldwide market value of the registrant's voting and non-voting common equity, use the average of such aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition.

(B) For a combination between entities or businesses under common control, this test is

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) In all other cases, this test is met when the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(ii) Asset Test. This test is met when the registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total assets (after intercompany eliminations) 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) This test is met when:

(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 before income taxes (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 from continuing operations (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 did not have material revenue in each of the two most recently completed fiscal years.

(B) When determining the income component in paragraph (w)(1)(iii)(A)(I) of this section:

(I) If a net loss from continuing operations before income taxes (after intercompany eliminations) 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 before income taxes (after intercompany eliminations) 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) of this section does not apply and the absolute value of the registrant's and its subsidiaries' consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) 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 must not be aggregated with entities reporting income where the test involves combined entities, as in the case of determining whether summarized financial data must be presented or whether the aggregate impact specified in §§ 210.3-05(b)(2)(iv) and 210.3-14(b)(2)(i)(C) is met, 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 sum of 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 (except, for purposes of § 210.6-11, the absolute value of the change in net assets resulting from operations of 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 absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years, then the registrant may compute both conditions of the income 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) must 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 must 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 will 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 does 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 registering an offering of securities to the security holders of the business to be acquired, then the financial statements specified in §§ 210.3-01 and 210.3-02 must 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 must 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 must be filed for the periods specified in this paragraph (b)(2) or such shorter period as the business has been in existence. Determine the periods for which such financial statements are to be filed 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 must 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 must 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 for any condition, the registrant must provide the disclosure specified in paragraphs (b)(2)(iv)(A) and (b)(2)(iv)(B) of this section, however in determining the aggregate impact of the investment test condition also include the aggregate impact calculated in accordance with § 210.3-14(b)(2)(ii) of any acquired or to be acquired real estate operations specified in § 210.3-14(b)(2)(i)(C). In determining whether the income test condition (*i.e.* both the revenue component and the income or loss from continuing operations component) exceeds 50 percent, the businesses specified in this paragraph reporting losses must be aggregated separately from those reporting income. If either group exceeds 50 percent, paragraphs (b)(2)(iv)(A) and (b)(2)(iv)(B) of this section will apply to all of the businesses specified in this paragraph and will not be limited to either the businesses with losses or those with income.

(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 and real estate operations, 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 or real estate operation for which financial statements are not yet required based on paragraph (b)(4)(i) of this section or § 210.3-14(b)(3)(i).

(3) The determination must be made using § 210.11-01(b)(3) and (b)(4).

(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 must

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 specified in paragraph (b)(2)(ii) of this section 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 at least nine months. Separate financial statements of the acquired business specified in paragraph (b)(2)(iii) of this section 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.* Financial statements of an acquired or to be acquired foreign business (as defined in § 210.1-02(l)) meeting the requirements of Item 17 of Form 20-F (§ 249.220f of this chapter) will satisfy this section. Such financial statements may be reconciled to U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) if the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB. This reconciliation must generally follow the form and content requirements in Item 17(c) of Form 20-F; however, accommodations in Item 17(c)(2) of Form 20-F that would be inconsistent with IFRS-IASB must not be applied, and IFRS 1, *First-time*

*Adoption of International Financial Reporting Standards*, may be applied.

(d) *Financial statements of an acquired or to be acquired business that would be a foreign private issuer if it were a registrant.* Financial statements of an acquired or to be acquired business that is not a foreign business (as defined in § 210.1-02(I)), but would qualify as a foreign private issuer (as defined in § 230.405 and § 240.3b-4) if it were a registrant may be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP or, if the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB, may be prepared according to a comprehensive basis of accounting principles other than U.S. GAAP or IFRS-IASB and must be reconciled to IFRS-IASB or to U.S. GAAP. This reconciliation must generally follow the form and content requirements in Item 17(c) of Form 20-F; however, accommodations in Item 17(c)(2) of Form 20-F that would be inconsistent with IFRS-IASB must not be applied, and IFRS 1, *First-time Adoption of International Financial Reporting Standards*, may be applied.

(e) *Financial statements for net assets that constitute a business.* For an acquisition of net assets that constitutes a business (e.g., an acquired or to be acquired product line), the financial statements prepared and audited in accordance with this regulation may be abbreviated financial statements prepared in accordance with paragraph (e)(2) of this section if the business meets all of the qualifying conditions in paragraph (e)(1) of this section.

(1) Qualifying conditions:

(i) The total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20 percent or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal

year.

(ii) Separate financial statements for the business have not previously been prepared;

(iii) The acquired business was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable) or division during the periods for which the acquired business financial statements would be required; and

(iv) The seller has not maintained the distinct and separate accounts necessary to present financial statements that, absent this paragraph (e), would satisfy the requirements of this section and it is impracticable to prepare such financial statements.

(2) Presentation requirements:

(i) The balance sheet may be a statement of assets acquired and liabilities assumed;

(ii) The statement of comprehensive income must include expenses incurred by or on behalf of the acquired business during the pre-acquisition financial statement periods to be presented including, but not limited to, costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development, but may otherwise omit corporate overhead expense, interest expense for debt that will not be assumed by the registrant or its subsidiaries consolidated, and income tax expense. The title of the statement of comprehensive income must be appropriately modified to indicate it omits certain expenses; and

(iii) The notes to the financial statements must include:

(A) A description of the type of omitted expenses and the reason(s) why they are excluded from the financial statements.

(B) An explanation of the impracticability of preparing financial statements that include

the omitted expenses.

(C) 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.

(D) 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) 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, must be provided for each full year of operations presented for an acquired or to be acquired business that includes significant oil- and gas-producing activities (as defined in the FASB ASC Master Glossary). 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. The method of computation must be disclosed in a footnote.

(2) The financial statements prepared and audited in accordance with this regulation may consist of only statements of revenues and expenses that exclude expenses not comparable to the proposed future operations such as depreciation, depletion and amortization, corporate overhead, income taxes, and interest for debt that will not be assumed by the registrant or its subsidiaries consolidated 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 qualifying conditions specified in paragraph (e)(1) of this section are met.

(3) If the financial statements are presented in accordance with paragraph (f)(2) of this section, the disclosures specified in paragraph (e)(2)(iii) of this section must be provided.

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 will 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 § 210.8-01(e) 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 will satisfy a filing requirement of financial statements for one year of that time period only if the conditions described in paragraph (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. Amend § 210.3-09 by revising paragraph (a) to read as follows:

**§210.3-09 Separate financial statements of subsidiaries not consolidated and 50 percent or**

**less owned persons.**

(a) If any of the conditions set forth in § 210.1-02(w), substituting 20 percent for 10 percent in the tests used therein to determine a significant subsidiary, are met for a majority-owned subsidiary not consolidated by the registrant or by a subsidiary of the registrant, separate financial statements of such subsidiary must be filed. Similarly, if either the first or third condition set forth in §210.1-02(w)(1), substituting 20 percent for 10 percent, is met by a 50 percent or less owned person accounted for by the equity method either by the registrant or a subsidiary of the registrant, separate financial statements of such 50 percent or less owned person must be filed.

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6. 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 this regulation (including the independence standards in § 210.2-01 or, alternatively if the real estate operation 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 must 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 will 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 will 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 does 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 registering an offering of securities to the security holders of the real estate operation to be acquired, then the financial statements specified in paragraph (c) of this section and the supplemental information specified in paragraph (f) of this section must 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 must 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 must 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 must be determined using the investment test 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 must 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) of this section, exceeds 50 percent, the registrant must provide the disclosures specified in paragraphs (b)(2)(i)(C)(1) and (b)(2)(i)(C)(2) of this section. If there are also businesses acquired or to be acquired as described in § 210.3-05(b)(2)(iv), the requirements in § 210.3-05(b)(2)(iv) will apply instead.

(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.

(ii) 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 “investments in” the tested real estate operation.

(iii) The determination must be made using § 210.11-01(b)(3) and (b)(4).

(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 must 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 specified in paragraph (b)(2)(i)(B) of this section 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 at least nine months.

(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 must 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 a foreign real estate operation.* Financial Statements of an acquired or to be acquired foreign business (as defined in § 210.1-02(I)) that is a real estate operation, specified in paragraph (c) of this section and meeting the requirements of Item 17 of Form 20-F (§ 249.220f of this chapter), will satisfy this section. Such financial statements may be reconciled to U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) if the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB. This reconciliation must generally follow the form and content requirements in Item 17(c) of Form 20-F; however, accommodations in Item 17(c)(2) of Form 20-F that would be inconsistent with IFRS-IASB will not be applied, and IFRS 1, *First-time Adoption of International Financial Reporting Standards*, may be applied.

(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.* Financial statements of an acquired or to be acquired real estate operation that is not a foreign business (as defined in § 210.1-02(I)), but would qualify as a foreign private issuer (as defined in § 230.405 and § 240.3b-4) if it were a registrant, may be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP or, if the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB, may be prepared according to a comprehensive basis of accounting principles other than U.S. GAAP or IFRS-IASB and must be reconciled to IFRS-IASB or to U.S. GAAP. This reconciliation must generally follow the form and content requirements in Item 17(c) of Form 20-F; however, accommodations in Item 17(c)(2) of Form 20-F that would be inconsistent with IFRS-IASB will not be applied, and IFRS 1, *First-time Adoption of International Financial*

*Reporting Standards*, may be applied.

(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) of this section, 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.

7. 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”.

8. 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”.

9. 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”.

10. 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”.

11. 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”.

12. 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 described in §§ 210.3-01 and 210.3-02, or § 210.3-18, as applicable, 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 must 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. Among the facts and circumstances

which should be considered in evaluating whether a fund acquisition has occurred or will occur are whether it will result in the acquisition by the registrant of all or substantially all of the portfolio investments held by another fund.

(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 will be treated under this section as if they are a single acquisition. For purposes of this section, funds will 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 does 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) of this section must be filed, except as provided otherwise for filings on Form N-14 (§ 239.23 of this chapter). The financial statements covering the fiscal year must 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 Form 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) of this section or such shorter period as the fund has been in existence and the supplemental information specified

in paragraph (d) of this section must be filed. Whether such financial statements and supplemental information are to be filed must 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 must be filed. If the acquired fund is subject to § 210.3-18, then the financial statements for the periods described therein must be filed. For all other acquired funds, the financial statements for the most recent fiscal year and the most recent interim period must be filed. The registrant must 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 must provide financial statements for any fund acquired or to be acquired for which financial statements are not yet required by paragraph (b)(2)(i) of this section. If any of the acquired funds are subject to § 210.3-18, then the financial statements for the periods described therein must be filed. For any other acquired funds, the financial statements for the most recent fiscal year and the most recent interim period must be filed. The registrant must also provide the supplemental financial information in paragraph (d) of this section for such funds.

(3) The determination must 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 and the supplemental information specified in paragraph (d) of this section need only to be filed once and not included in any subsequent filing or shareholder report.

(c) *Acquisitions involving private funds or private accounts.* If the fund acquired or 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 may 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 acquired or to be acquired.

(d) *Supplemental financial information.*

(1) Supplemental financial information must 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 accounting policies of the acquired fund when compared to the registrant.

(2) With respect to any fund acquisition, registered investment companies and business development companies must 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.

13. Revise § 210.8-01 to read as follows:

**§ 210.8-01 General Requirements for Article 8.**

Sections 210.8-01 to 210.8-08 shall be applicable to financial statements filed for smaller reporting companies. These sections are not applicable to financial statements prepared for the purposes of Item 17 or Item 18 of Form 20-F.

(a) Financial statements of a smaller reporting company, as defined by §229.10(f)(1) of this chapter, its predecessors or any businesses to which the smaller reporting company is a successor shall be prepared in accordance with generally accepted accounting principles in the United States.

(b) Smaller reporting companies electing to prepare their financial statements with the form and content required in this article need not apply the other form and content requirements in Regulation S-X with the exception of the following:

(1) The report and qualifications of the independent accountant shall comply with the requirements of §§ 210.2-01 through 210.2-07 (Article 2 of this part); and

(2) The description of accounting policies shall comply with § 210.4-08(n); and

(3) Smaller reporting companies engaged in oil and gas producing activities shall follow the financial accounting and reporting standards specified in § 210.4-10 with respect to such activities.

(c) Financial statements for a subsidiary of a smaller reporting company that issues securities guaranteed by the smaller reporting company or guarantees securities issued by the smaller reporting company must be presented as required by § 210.3-10, except that the periods presented are those required by § 210.8-02.

(d) Financial statements for a smaller reporting company's affiliates whose securities constitute a substantial portion of the collateral for any class of securities registered or being registered must be presented as required by § 210.3-16, except that the periods presented are those required by § 210.8-02.

(e) The Commission, where consistent with the protection of investors, may permit the omission of one or more of the financial statements or the substitution of appropriate statements of comparable character. The Commission by informal written notice may require the filing of other financial statements where necessary or appropriate.

(f) § 210.3-06 applies to the preparation of financial statements of smaller reporting companies.

**§ 210.8-03 [Amended]**

14. Remove and reserve § 210.8-03(b)(4).

15. 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.

16. Revise § 210.8-05 to read as follows:

**§ 210.8-05 Pro forma financial information.**

(a) Pro forma financial information must be disclosed when any of the conditions in § 210.11-01 exist.

(b) The preparation, presentation and disclosure of pro forma financial information must 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).

17. 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.

18. 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 must 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 will 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) (i.e. the investment test condition), substituting 20 percent for 10 percent, as modified by the guidance in § 210.3-14(b)(2)(ii).

(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 must be made, except as noted in paragraph (b)(4) of this section for the continuous offerings described therein, by using:

(i) For amounts derived from financial statements, the registrant's most recent annual consolidated financial statements required to be filed at or prior to the date of acquisition or disposition and the business's pre-acquisition or pre-disposition financial statements for the same fiscal year as the registrant or, if the fiscal years differ, the business's most recent fiscal year that would be required if the business had the same filer status as the registrant, however the determination may be made using:

(A) The financial statements for the business described in § 210.3-05(e) or § 210.3-05(f) if the business meets the conditions for presenting those financial statements.

(B) Pro forma amounts 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 and only include Transaction Accounting Adjustments (*see* § 210.11-02(a)(6)(i)), provided that:

(1) 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; and

(2) If a registrant has used pro forma amounts to determine significance of an acquisition or disposition, it must continue to use pro forma amounts to determine significance of acquisitions and dispositions through the filing date of its next annual report on Form 10-K (§

249.310 of this chapter) or Form 20-F (§ 249.220f of this chapter); or

(C) 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 date of 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).

(ii) If the business is a related business (*see* § 210.3-05(a)(3)), combined pre-acquisition financial statements of the group of related businesses for the fiscal year specified in paragraph (b)(3)(i) of this section.

(4) 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, the income test condition does not apply, and the determination must be made for the investment test condition, when it is based on the total assets of the registrant and its subsidiaries consolidated, and the asset test condition, if applicable, using the following for the registrant:

(A) During the distribution period, total assets as of the date of acquisition or disposition plus the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months, except that for acquisitions total assets must exclude the acquired business; and

(B) After the distribution period ends and until the next Form 10-K is filed, total assets as of the date of acquisition or disposition, except that for acquisitions total assets must exclude the acquired business; and

(C) After that next Form 10-K is filed, the guidance in paragraph (b)(3).

(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).

\* \* \* \* \*

19. Revise § 210.11-02 to read as follows:

**§ 210.11-02 Preparation requirements.**

(a) *Form and content.*

(1) Pro forma financial information must 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 must 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 must be used for purposes of this test.

Notwithstanding these tests, *de minimis* amounts need not be shown separately.

(4) Pro forma statements will 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 must 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 must include, and be limited to, the following pro forma adjustments, except as noted in paragraph (a)(7) of this section:

(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), qualification date (for Regulation A offering 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. Such adjustments must be made whether or not the pro forma balance sheet is presented pursuant to paragraph (c)(1) of this section. 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) *Autonomous Entity Adjustments*. Adjustments that depict the registrant as an autonomous entity if the condition in §210.11-01(a)(7) is met. Autonomous Entity Adjustments must be presented in a separate column from Transaction Accounting Adjustments.

(7) *Management's Adjustments*. Adjustments depicting synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given may, in the registrant's discretion, be presented if in its management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and the following conditions are met:

(i) *Basis for Management's Adjustments*

(A) There is a reasonable basis for each such adjustment.

(B) The adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented. If such adjustments reduce expenses, the reduction must not exceed the amount of the related expense historically incurred during the pro forma period presented.

(C) The pro forma financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed. When synergies are presented,

any related dis-synergies must also be presented.

(ii) *Form of Presentation.*

(A) If presented, Management's Adjustments must be presented in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data specified in paragraph (a)(9) of this section to such amounts after giving effect to Management's Adjustments.

(B) Management's Adjustments included or incorporated by reference into a registration statement, proxy statement, Regulation A offering statement, or Form 8-K should be as of the most recent practicable date prior to the effective date, mail date, qualification date, or filing date as applicable, which may require that they be updated if previously provided in a Form 8-K that is appropriately incorporated by reference.

(C) If Management's Adjustments will change the number of shares or potential common shares, reflect the change within Management's Adjustments 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.

(D) The explanatory notes must also include disclosure of the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment.

INSTRUCTION TO PARAGRAPH (a)(7). Any forward-looking information supplied is

expressly covered by the safe harbor rules under § 230.175 and § 240.3b-6 of this chapter.

(8) All pro forma adjustments should be referenced to notes that clearly explain the assumptions involved.

(9)(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 must be presented on the face of the pro forma condensed statement of comprehensive income and only give effect to Transaction Accounting Adjustments and Autonomous Entity Adjustments.

(ii) The number of shares used in the calculation of the pro forma per share amounts must 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.

(10) 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.

(11) The accompanying explanatory notes must 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 Autonomous Entity Adjustment, a description of the adjustment (including the material uncertainties), the material assumptions, the calculation of the adjustment, and additional qualitative information about the Autonomous Entity Adjustments, if any, necessary to give a fair and balanced presentation of the pro forma financial information.

(12) A registrant must 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 pro forma financial information, or summaries of such information, elsewhere

in a filing that excludes material transactions for which pro forma effect is required to be given.

(iii) Present the pro forma amounts in paragraph (a)(7) of this section elsewhere in a filing without also presenting with equal or greater prominence the amounts specified in paragraph (a)(7) of this section to which they are required to be reconciled and a cross-reference to that reconciliation.

(iv) 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 must 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 must be disclosed in a note.

(3) *Business dispositions.* Transaction Accounting Adjustments giving effect to the disposition of a business must not decrease historically incurred compensation expense for employees who were not, or will not be, transferred or terminated as of the disposition date.

(4) *Multiple transactions.*

(i) When consummation of more than one transaction has occurred, or is probable, the

pro forma financial information must 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 must 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 must be filed unless the transaction is already reflected in such balance sheet.

(2)(i) Pro forma condensed statements of comprehensive income must 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 must 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 must 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 must 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 must 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 must 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 must 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.

20. 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**

21. 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.

\* \* \* \* \*

22. 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 section; however, if the registrant is a registered investment company or a business development company, the tested subsidiary meets any of the conditions in paragraph (4) of this section instead of any of the conditions in paragraphs (1), (2), or (3) of this section. A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles (U.S. GAAP) must 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) must use amounts determined under IFRS-IASB.

(1) Investment Test.

(i) For acquisitions, other than those described in paragraph (ii), and dispositions this test is met when 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.

(A) For acquisitions, the “investments in” the tested subsidiary is the consideration transferred, adjusted to exclude 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. It must 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, it must include all contingent consideration, except contingent consideration for which the likelihood of payment is remote.

(B) For dispositions, the “investments in” the tested subsidiary is the fair value of the consideration, including contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant’s voting and non-voting common equity, 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.

(C) When determining the aggregate worldwide market value of the registrant’s voting and non-voting common equity, use the average of such aggregate worldwide market value calculated daily for the last five trading days of the registrant’s most recently completed month ending prior to the earlier of the registrant’s announcement date or agreement date of the acquisition or disposition.

(ii) For a combination between entities or businesses under common control, this test is 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) In all other cases, this test is met when the registrant’s and its other subsidiaries’ investments in and advances to the tested subsidiary exceed 10 percent of the total assets of the

registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(2) Asset Test. This test is met when the registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total assets (after intercompany eliminations) 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) This test is met when:

(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 before income taxes (after intercompany eliminations transactions between the tested subsidiary and the registrant and its consolidated subsidiaries) 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 from continuing operations (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 did not have material revenue in each of the two most recently completed fiscal years.

(ii) When determining the income component in paragraph (3)(i)(A) of this section:

(A) If a net loss from continuing operations before income taxes (after intercompany eliminations) 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 before income taxes (after intercompany eliminations) 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;

(B) Compute the test using the average described herein if the revenue component in paragraph (3)(i)(B) in this section does not apply and the absolute value of the registrant's and its subsidiaries' consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) 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

(C) Entities reporting losses must not be aggregated with entities reporting income where the test involves combined entities, as in the case of determining whether summarized financial data must be presented or whether the aggregate impact specified in §§ 210.3-05(b)(2)(iv) and 210.3-14(b)(2)(i)(C) is met, except when determining whether related businesses meet this test for purposes of §§ 210.3-05 and 210.8-04.

(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 sum of 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 (except, for purposes of § 210.6-11, the absolute value of the change in net assets resulting from operations of 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 (4)(i) of this section) condition exceeds 5 percent. However, if the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years, then the registrant may compute both conditions of the income 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**

23. 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.

\* \* \* \* \*

24. Form S-11 (referenced in § 239.18) is amended to revise Item 9 to read as follows:

**Note: The text of Form S-11 does not, and this amendment will not, appear in the Code of Federal Regulations.**

#### **FORM S-11**

\* \* \* \* \*

#### **Item 9. Selected Financial Data.**

File the information required by Item 301 of Regulation S-K (§ 229.301 of this chapter).

25. 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 must 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, unless it is an

investment company subject to § 210.3-18 in which case the financial statements for the periods described therein must be filed;

2. if the company to be acquired is a private fund, then the required financial statements may 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).

\* \* \* \* \*

26. Amend Part F/S of Form 1-A (referenced in § 239.90) by revising paragraph (b)(7)(iv) to read as follows:

**Note: The text of Form 1-A does not, and this amendment will not, appear in the Code of Federal Regulations.**

**FORM 1-A**  
**REGULATION A OFFERING STATEMENT**  
**UNDER THE SECURITIES ACT OF 1933**

**GENERAL INSTRUCTIONS**

\* \* \* \* \*

**Part F/S**

\* \* \* \* \*

**(b) Financial Statements for Tier 1 Offerings \* \* \***

(7) \* \* \*

(iv) *Pro Forma Financial Statements.* File pro forma financial information as described in Rule 8-05 of Regulation S-X.

\* \* \* \* \*

**PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

27. 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.

\* \* \* \* \*

28. 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 paragraphs (1), (2), or (3) of this section; however, if the registrant is a registered investment company or a business development company, the tested subsidiary meets any of the conditions in paragraph (4) of this section instead of any of the conditions in paragraphs (1), (2), or (3) of this section. A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally

Accepted Accounting Principles (U.S. GAAP) must 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) must use amounts determined under IFRS-IASB.

(1) Investment Test.

(i) For acquisitions, other than those described in paragraph (ii), and dispositions this test is met when 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.

(A) For acquisitions, the "investments in" the tested subsidiary is the consideration transferred, adjusted to exclude 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. It must 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, it must include all contingent consideration, except contingent consideration for which the likelihood of payment is remote.

(B) For dispositions, the "investments in" the tested subsidiary is the fair value of the consideration, including contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant's voting and non-voting common equity,

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.

(C) When determining the aggregate worldwide market value of the registrant's voting and non-voting common equity, use the average of such aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition.

(ii) For a combination between entities or businesses under common control, this test is 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) In all other cases, this test is met when the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

(2) Asset Test. This test is met when the registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total assets (after intercompany eliminations) 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) This test is met when:

(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 before income taxes (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 from continuing operations (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 did not have material revenue in each of the two most recently completed fiscal years.

(ii) When determining the income component in paragraph (3)(i)(A) of this section:

(A) If a net loss from continuing operations before income taxes (after intercompany eliminations) 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 before income taxes (after intercompany eliminations) 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;

(B) Compute the test using the average described herein if the revenue component in paragraph (3)(i)(B) in this section does not apply and the absolute value of the registrant's and its subsidiaries' consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) 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

(C) Entities reporting losses must not be aggregated with entities reporting income where the test involves combined entities, as in the case of determining whether summarized financial data must be presented or whether the aggregate impact specified in §§ 210.3-05(b)(2)(iv) and 210.3-14(b)(2)(i)(C) is met, except when determining whether related businesses meet this test for purposes of §§ 210.3-05 and 210.8-04.

(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 sum of 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 (except, for purposes of § 210.6-11, the absolute value of the change in net assets resulting from operations of 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 (4)(i) in this section) condition exceeds 5 percent. However, if the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years, then the registrant may compute both conditions of the income 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 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934**

29. 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.

30. 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 will 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

percent 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)). 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; or

(iii) in the case of a business development company, if the amount paid for such assets exceeded 10 percent 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 and

210.3-14), or Rules 8-04 or 8-06 of Regulation S-X (17 CFR 210.8-04 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 must 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, file 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 must 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 do 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, Rule 6-11, Rule 8-04, and Rule 8-06 of Regulation S-X (17 CFR 210.3-05, 210.3-14, 210.6-11, 210.8-04, and 210.8-06), 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, Rule 6-11, Rule 8-04, and Rule 8-06 of Regulation S-X (17 CFR 210.3-05, 210.3-14, 210.6-11, 210.8-04, and 210.8-06), 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).

\* \* \* \* \*

31. 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) File 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)) must 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**

32. 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.

\* \* \* \* \*

33. Amend § 270.8b-2 to revise paragraph (k) of 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 sum of 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) of this section) condition exceeds 5 percent. However, if the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years, then the registrant may compute both conditions of the income 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**

34. 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.

\* \* \* \* \*

35. 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 20, 2020.

Vanessa A. Countryman  
Secretary