

SEC Proposes to Improve Disclosures Relating to Acquisitions and Dispositions of Businesses

On May 3, 2019, the Securities and Exchange Commission (SEC) voted to propose rule amendments to improve the information that investors receive regarding the acquisition and disposition of businesses. The proposed amendments are also intended to facilitate more timely access to capital and to reduce complexity and compliance costs of these financial disclosures.

The proposed amendments relate to the financial disclosure requirements in Rules 3-05, 3-14, and Article 11 of Regulation S-X, as well as related rules and forms, for financial statements of businesses acquired or to be acquired and for business dispositions. The SEC also proposed new Rule 6-11 of Regulation S-X and amendments to Form N-14 for financial reporting of acquisitions involving investment companies. The proposed amendments are the result of the SEC's ongoing comprehensive evaluation of disclosure requirements, including the Commission's 2015 Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant.¹

In the SEC's press release, Chairman Jay Clayton commented "The proposed rules are, first and foremost, intended to ensure that investors receive the financial information necessary to understand the potential effects of significant acquisitions or dispositions. The staff's work on the proposed rule amendments reflects years of experience. Their work to eliminate unnecessary costs and burdens of the current rules — which in some cases have been significant and frustrated otherwise attractive transactions — while at the same time improving the disclosures investors receive should be applauded."

Background

When an issuer acquires a significant business, other than a real estate operation, Rule 3-05 of Regulation S-X generally requires an issuer to provide separate audited annual and unaudited interim pre-acquisition financial statements of that business. The number of years of financial information that must be provided depends on the relative significance of the acquisition to the issuer.²

Article 11 of Regulation S-X also requires issuers to file unaudited pro forma financial information relating to the acquisition or disposition. Pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the issuer and the acquired or disposed business, including adjustments intended to show how the acquisition or disposition might have affected those financial statements.

Rule 3-05 also applies to issuers that are registered investment companies and business development companies. Investment company issuers differ from non-investment company issuers in that they principally invest for returns from capital appreciation and/or investment income, are required to recognize changes in value to their portfolio investments each reporting period, and generally do not consolidate entities they control or use equity method accounting. Due to the nature of investment companies, under the current rules it is often unclear how to apply these reporting requirements to acquired funds.

Proposed Amendments

According to the SEC's press release, the proposed changes are intended to: improve for



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investors the financial information about acquired and disposed businesses; facilitate more timely access to capital; and reduce the complexity and cost to prepare the disclosure. The proposed changes would, among other things:

- update the significance tests under these rules by revising the investment test and the income test, expanding the use of pro forma financial information in measuring significance, and conforming the significance threshold and tests for a disposed business;
- require the financial statements of the acquired business to cover up to the two most recent fiscal years rather than up to the three most recent fiscal years;
- permit disclosure of financial statements that omit certain expenses for certain acquisitions of a component of an entity;
- clarify when financial statements and pro forma financial information are required;
- permit the use in certain circumstances of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board;
- no longer require separate acquired business financial statements once the business has been included in the registrant's post-acquisition financial statements for a complete fiscal year;
- align Rule 3-14 with Rule 3-05 where no unique industry considerations exist;
- clarify the application of Rule 3-14 regarding the determination of significance, the need for interim income statements, special provisions for blind pool offerings, and the scope of the rule's requirements;
- amend the pro forma financial information requirements to improve the content and relevance of such information; more specifically, these improvements would include disclosure of "Transaction Accounting Adjustments," reflecting the accounting for the transaction; and "Management's Adjustments," reflecting reasonably estimable synergies and transaction effects;
- make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X;
- add a definition of significant subsidiary that is tailored for investment companies; and
- add a new Rule 6-11 and amend Form N-14 to cover financial reporting for fund acquisitions by investment companies and business development companies.

Request for Comment

The proposal will be subject to a 60-day public comment period following publication in the Federal Register. The SEC is requesting comment on all aspects of its economic analysis, including the potential costs and benefits of the proposed amendments and alternatives thereto, and whether the rules, if adopted, would promote efficiency, competition, and capital formation or have an impact on investor protection.

The proposed amendments can be [found here](#).

¹ Securities Exchange Commission Release No. 33-9929 (Sept. 25, 2015) [80 Fed. Reg. 59083 (Oct. 1, 2015)].

² Similarly, Rule 3-14 of Regulation S-X addresses the unique nature of real estate operations and requires an issuer that has acquired a significant real estate operation to file financial statements with respect to such acquired operation.