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SEC Proposes Rule Changes with Potential Benefits for REITs, Funds, and Business Development Companies

June 20, 2019

The Securities and Exchange Commission ("SEC" or "Commission") recently proposed a number of changes to Regulation S-X and related rules and forms that could significantly streamline the requirements for filing financial statements in connection with significant acquisitions.[1] If adopted in their current form, these changes would directly impact real estate investment trusts ("REITs"), registered investment companies, and business development companies ("BDCs") by substantially rewriting the rules that require reporting companies to file separate financial statements for acquired real estate operations and funds. The proposed amendments are intended to eliminate unnecessary costs to companies while improving the disclosure available to investors.[2]

As proposed, Rule 3-14 of Regulation S-X ("Rule 3-14") would be amended to align more closely with the disclosure requirements that apply to business acquisitions under Rule 3-05 of Regulation S-X ("Rule 3-05"). The amendments also would codify a number of SEC staff interpretations that have developed over the years to address ambiguities in Rule 3-14. Additionally, the Commission proposed new, more tailored requirements relating to acquisitions by registered investment companies and BDCs (collectively, "investment companies") to better address the specific attributes of these entities.

The proposal is subject to a 60-day public comment period, which ends on July 29, 2019.

Background

When a registrant acquires a business, Rule 3-05 generally requires separate pre-acquisition financial statements of that business to be filed if the acquisition is significant to the registrant. Similarly, Rule 3-14 requires a registrant to file pre-acquisition financial statements for an acquired real estate operation ("property")[3] that is significant. Article 6 of Regulation S-X, which provides specialized disclosure requirements for investment companies, does not prescribe specific disclosure for acquired funds. Instead, those entities must follow Rule 3-05 to determine when pre-acquisition financial statements are required.

Over time, the disclosure requirements for an acquired business under Rule 3-05 have diverged from the requirements for an acquired property under Rule 3-14, creating uncertainty about the timing and content of disclosures required under Rule 3-14. This uncertainty led the SEC staff to publish a fairly significant body of interpretive guidance that has been widely followed by reporting companies.[4] Investment companies often face similar uncertainty about how to apply the requirements of Rule 3-05 in the context of acquired funds, primarily because the significance tests are not tailored to fund operations and accounting. The proposed amendments to Regulation S-X would address some of these inconsistencies and uncertainties, while also updating the broader disclosure framework for business acquisitions.

Financial Statements of Real Estate Operations Acquired or to be Acquired – Rule 3-14

Currently, Rule 3-14 requires a registrant to file separate financial statements for real estate operations that the registrant has acquired or proposes to acquire. The financial statement requirement is triggered when an acquired property is individually significant at the 10% level or higher. In some cases, financial statements must be filed when individually insignificant acquisitions are significant in the aggregate. Typically, the registrant must provide audited financial statements for the most recent fiscal year and unaudited financial statements for the most recent interim period, as well as pro forma financial information.

Significance. Rule 3-14 currently does not prescribe a quantitative significance threshold. The SEC staff interprets significance for purposes of Rule 3-14 at the 10% level or higher, *i.e.,* financial statements of an acquired property must be provided when it is significant at the 10% level.[5] The proposed amendments to Rule 3-14 would increase the threshold to 20%, which would align Rule 3-14 with the 20% significance threshold that applies to acquired businesses under Rule 3-05.

Periods Required. Currently, Rule 3-14 requires only one year of audited financial statements for most acquired properties.[6] The SEC staff has advised registrants also to provide acquired property financial information for the most recent interim period, although it is not expressly required under Rule 3-14. Rule 11-01 of Regulation S-X requires registrants to file pro forma financial information for acquisitions of one or more properties that are significant, and Rule 11-02 of Regulation S-X specifies that pro forma information must include interim periods.

The proposed amendments would align Rule 3-14 with Rule 3-05, requiring one year of audited financial statements and the most recent interim period for acquisitions above 20% significance.[7] Separate financial statements would not need to be presented once the operating results of the acquired property have been reflected in the registrant's audited financial statements for one year.

Individually Insignificant Acquisitions. Rule 3-14 currently does not expressly require a registrant to provide financial statements when individually insignificant acquisitions are significant in the aggregate. The SEC staff, however, has advised companies to provide certain financial information when acquired properties in the aggregate exceed 10% of the registrant's total assets. At that threshold, companies are expected to provide Rule 3-14 financial statements for each property that is 5% or more significant and for a substantial majority of the individually insignificant acquisitions based on purchase price.

The proposed amendments would reduce the disclosure requirements for acquisitions that are significant in the aggregate. As proposed, companies would measure the aggregate impact of acquisitions completed or probable since the date of the most recent audited balance sheet. If the aggregate impact exceeds 50% significance, the registrant would be required to provide pro forma financial information that reflects the aggregate impact of the acquisitions. Separate financial statements would be required for any individual acquisition above the 20% significance level that is probable or was completed no more than 74 days before the filing date. As proposed, Rule 3-14 would make clear that these requirements would apply only to registration and proxy statements, consistent with current staff interpretation.

Content of Financial Statements and Supplemental Disclosure. Rule 3-14 currently provides that financial statements of an acquired property may be limited to audited income statements that exclude items not comparable to the proposed future operations of the property, such as mortgage interest, leasehold rental, depreciation, corporate expenses, and federal and state income taxes. Additionally, companies generally are required to disclose the material factors considered in assessing the property, including sources of revenue and expense.

Under the amended rule, if adopted as proposed, audited statements of revenues and expenses would satisfy the requirements of Rule 3-14. Expenses not comparable to the proposed future operations of the acquired property would be excluded, consistent with current practice. The proposed amendments would impose a new requirement to include disclosure in the notes to the financial statements about expenses excluded from the financial statements, as well as information about the property's operating, investing, and financing cash flows, to the extent available.

Measurement of Significance. Rule 3-14 currently does not specify how a company should determine whether an acquired or to-be acquired property is significant. By contrast, Rule 3-05 expressly adopts the tests specified in the definition of "significant subsidiary" found in Rule 1-02(w) of Regulation S-X ("Rule 1-02(w)"). The proposed amendments would better align Rule 3-14 with Rule 3-05 by expressly requiring significance to be measured using the investment test for significant subsidiary under Rule 1-02(w), with certain modifications.

Under the proposed rules, a registrant would measure significance of an acquired property using the investment test of Rule 1-02(w), which would be consistent with current practice but not currently specified in the rule. The Commission also proposed amendments to Rule 1-02(w) that would change how registrants apply the investment test. Except in the case of a business combination, the registrant's investment in the acquired property would be measured against the registrant's market capitalization or, in the absence of market value, the registrant's total consolidated assets as of the end of its most recently completed fiscal year. Currently, the investment test in Rule 1-02(w) measures investment in the acquisition against the registrant's total assets.

Blind Pool REITs. As proposed, amendments to Rule 3-14 would codify long-standing staff interpretation that applies a modified significance test for blind pool offerings by REITs. In the early stages of building a portfolio using proceeds from a continuous offering, virtually all acquisitions would be significant if measured against total assets. To address this anomaly, the SEC staff currently advises registrants to measure the significance of an acquisition during the initial distribution period using the sum of (i) total assets as of the date of the acquisition and (ii) offering proceeds that the registrant expects in good faith to raise over the next 12 months.[8] The proposed amendments to Rule 3-14 would codify this significance test for blind pool REITs conducting continuous offerings over an extended period of time.

Triple Net Leases. While not specifically addressed in Rule 3-14, under current practice a company that acquires a property that is triple net leased to a single tenant may be required to provide full audited financial statements of the lessee or guarantor of the lease in lieu of Rule 3-14 financial statements of the acquired property. The proposed amendments would eliminate this practice. If adopted as proposed, registrants would no longer be required to provide audited lessee financial statements, regardless of asset concentration. Instead, triple net leased properties would be treated the same as any other acquired property under the amended rule. This change would mark a notable departure from current staff practice that could ease the disclosure burden for registrants that acquire triple net leased properties with a single tenant.

Takeaway

If adopted, the proposed amendments to Rule 3-14 could reduce REIT disclosure obligations by increasing the significance threshold for property acquisitions from 10% to 20% and eliminating certain requirements to provide separate financial statements of individually insignificant properties when acquisitions are significant in the aggregate. The proposed amendments also would preserve and codify staff accommodations for measuring significance in blind pool offerings, while overturning current guidance that directs registrants to file tenant financial statements in connection with acquisitions of properties that are triple net leased to a single tenant.

Acquisitions Specific to Investment Companies

Currently, investment companies are required to comply with Rule 3-05 for acquisitions of other investment companies and private funds.[9] However, certain aspects of Rule 3-05 and the significance test under Rule 1-02(w) are either inapplicable to investment companies or inconsistent with other financial reporting requirements applicable to investment companies. The Commission proposed new Rule 6-11 of Regulation S-X ("Rule 6-11") and amendments to Rule 1-02(w) to provide rules that are more tailored to the attributes of, and the financial reporting scheme otherwise applicable to, investment companies.

Scope. Proposed Rule 6-11 would apply when an investment company acquires a fund. Rule 6-11 defines a "fund" as:

- any investment company as defined in Section 3(a) of the Investment Company Act of 1940, as amended (the "1940 Act"), including a BDC;
- any company that would be an investment company but for the exclusions provided by Sections 3(c)(1) and 3(c)(7) of the 1940 Act; or
- any private account managed by an investment adviser.

Proposed Rule 6-11 also would implement a facts and circumstances test to determine whether an investment company has "acquired" a fund.[10] While application of a facts and circumstances test is consistent with Rule 3-05, new Rule 6-11 would further identify the following circumstances that would be considered a fund acquisition:

- the acquisition of all or substantially all of the portfolio investments of the fund; and
- an acquisition of a fund's portfolio investments that would comprise all or substantially all of the initial assets of the registrant.[11]

Significance. Currently the definition of "significant subsidiary" in Rule 1-02(w) is used by investment companies in the context of Rule 3-05 and fund acquisitions. However, the three significance tests are based on financial measures not commonly reported by investment companies. Moreover, the significance tests in Rule 1-02(w) are different from the definition of "significant subsidiary" provided in Rule 8b-2 under the 1940 Act.

The proposed amendments would add a separate definition of "significant subsidiary" that would use significance tests that are specific to investment companies. The Commission also proposed conforming changes to Rule 8b-2 under the 1940 Act to incorporate the new definition. Under the proposal, investment companies would be subject to two new significance tests:

- an "investment test," under which a subsidiary would be considered significant if the value[12] of the investments in the subject subsidiary exceeds 10% of the value of total investments of the registrant and its consolidated subsidiaries as of the end of the most recently completed fiscal year; and
- an "income test," under which a subsidiary would be considered significant if the absolute value of the sum of (a) investment income from dividends, interest and other income, (b) net realized gains and losses on investments and (c) net change in unrealized gains and losses[13] on investments from the subsidiary in question exceeds:
    - 80% of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries on a consolidated basis for the most recently completed fiscal year; or
    - 10% of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries on a consolidated basis for the most recently completed fiscal year and the investment test described above is satisfied when 5% is substituted for 10%.

Periods Required. Currently, Rule 3-05 requires investment companies to provide between one and three years of audited financial statements in connection with a fund acquisition. As proposed, Rule 6-11 would require only a single year of audited financial statements. The proposed changes would align with the financial reporting obligations under Rule 3-18 of Regulation S-X, which allows registered investment companies to file only one year of audited financial statements in their registration statements. [14] In addition, the proposed Rule 6-11 would require interim and supplemental financial information at certain significance levels. As proposed, investment companies would be required to file separate financial statements for acquired funds as follows:

- If neither of the significance tests set forth under Rule 1-02(w), as amended, is satisfied at the 20% level, financial statements and supplemental information are not required.
- If either significance test is satisfied at the 20% level, financial statements for the most recent fiscal year and the most recent interim period must be filed, as well as certain supplemental financial information described below.
- If the aggregate impact to an investment company of acquired funds and probable acquisitions causes either significance test to be satisfied at the 50% level, financial statements for the most recent fiscal year and the most recent interim period must be filed for each such fund, as well as certain supplemental financial information described below.

Consistent with proposed changes to Rule 3-05 and Rule 3-14, separate financial statements of the acquired funds would no longer be required once the portfolio investments of the acquired fund have been reflected in the acquiring investment company's most recent audited balance sheet.[15]

Content of Financial Statements and Supplemental Disclosure. As proposed, Rule 6-11 generally would require financial statements of acquired funds to be prepared in accordance with Regulation S-X, including the schedules required by Article 12. The requirement to include Article 12 schedules, which are not required under either Rule 3-05 or Rule 3-14, reflects the Commission's belief that the most relevant financial information in the context of a fund acquisition is the schedule of investments that shows the portfolio assets being acquired.

If the fund to be acquired would be an investment company but for the exclusions provided by Sections 3(c)(1) and 3(c)(7) of the 1940 Act, then the financial statements provided need only comply with GAAP and Article 12. That is, a schedule of investments that complies with Article 12 would need to be produced, but otherwise GAAP-compliant financial statements would not need to be reissued to comply with the remainder of Regulation S-X. This could save significant time and expense associated with re-issuing and re-auditing historical financial statements for acquired private funds, including affiliated funds contributing assets in connection with formation transactions undertaken by certain closed-end funds and BDCs.

Rather than providing pro forma information, which is required for acquisitions of businesses or properties, respectively, proposed Rule 6-11 would require investment companies to provide certain supplemental financial disclosures, including:

- A pro forma fees and expenses table for the combined entity post-acquisition;[16]
- If any material changes in the portfolio holdings of the acquired fund will result from the acquisition due to investment restrictions, a pro forma schedule of investments of the acquired fund reflecting such changes, along with a narrative description of the changes; and
- A description of any material differences in the accounting policies of the acquired fund and the combined entity post-acquisition.

BDCs and Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries. BDCs currently are required to provide separate financial statements under Rule 3-09 or summarized financial information under Rule 4-08(g) for significant subsidiaries, including controlled portfolio companies. Under the current significance tests in Rule 1-02(w), BDCs may be required, absent SEC staff relief, to undertake the expense of providing financial statements for controlled portfolio companies that represent a small portion of the investment portfolio but, due to realized and unrealized gains or losses, represent a significant portion of the BDC's income for a period.

Under the proposed amendments to Rule 1-02(w), the denominator used in the investment test for investment companies would be total investments, rather than total assets, which would result in the significance test being satisfied at a lower investment level. This could require BDCs that make larger investments (as a percentage of their portfolio) to provide separate financial statements or summarized financial information for additional controlled portfolio companies under Rules 3-09 and 4-08(g).

The proposed amendments to the income test, on the other hand, are intended to avoid requiring investment companies to undertake the expense of providing financial statements for subsidiaries that represent less than 5% of the investment portfolio but represent a significant portion of the BDC's income for a period. This likely would require BDCs to provide either separate audited financial statements or summarized financial information for fewer of their controlled portfolio companies under Rules 3-09 and 4-08(g).

Takeaway

If adopted, the proposed amendments to Rule 1-02(w) and the addition of Rule 6-11 of Regulation S X should bring the financial reporting for acquisitions more in line with other financial reporting by investment companies and lower the costs associated with reporting fund acquisitions. However, the proposed amendments to Rule 1-02(w) could require certain investment companies to incur additional costs as they reassess those portfolio companies for which information is provided pursuant to Rule 3-09 or 4-08(g).

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[1] Amendments to Financial Disclosures about Acquired and Disposed Businesses, 84 Fed. Reg. 24600 (proposed May 3, 2019) (to be codified at 17 C.F.R. pts. 210, 230, 239, 240, 249, 270, 274).

[2] Press Release, *SEC Proposes to Improve Disclosures Relating to Acquisitions and Dispositions of Businesses* (May 3, 2019), available at https://www.sec.gov/news/press-release/2019-65.

[3] For purposes of Rule 3-14, the SEC staff has interpreted the term "real estate operations" to mean properties that generate revenues solely through leasing, such as office, apartment and industrial buildings, as well as shopping centers and malls. "Real estate operations" does not include properties that generate revenues from operations other than leasing real property, such as nursing homes, hotels, motels, golf courses, auto dealerships, and equipment rental operations. The amendments would provide a definition of "real estate operations" in Rule 3-14 that is consistent with staff interpretation. For purposes of this alert, "properties" and "property" refers to real estate operations subject to Rule 3-14.

[4] SEC - Div. of Corp. Fin., *Financial Reporting Manual*, § 2300, available at https://www.sec.gov/corpfin/cf-manual.

[5] The 10% significance threshold is consistent with the threshold for defining "significant subsidiary" in Rule 1-02(w) of Regulation S-X, but is different from the 20% significance threshold that applies under Rule 3-05.

[6] A company must provide three years of financial statements for properties acquired from related parties. The proposed amendments would eliminate this requirement and any distinction between properties acquired from related parties and those acquired from third parties.

[7] For proxy statements and registration statements on Forms S-4 or F-4, the registrant would be required to present acquired property financial statements for the periods specified by Rules 3-01 and 3-02 of Regulation S-X.

[8] SEC - Div. of Corp. Fin., *Financial Reporting Manual*, *supra* note 4 at § 2340.

[9] Investment companies must prepare their financial statements in accordance with Articles 1 through 4 of Regulation S-X, unless a special rule is set forth in Article 6 of Regulation S-X. *See* Rule 6-03 of Regulation S-X.

[10] Many of the attributes of a "business" as that term is used in Rule 3-05, such as revenue producing activity, physical facilities and production techniques, are not applicable to investment companies.

[11] This scenario would apply in connection with many of the formation transactions undertaken by closed-end funds and BDCs immediately prior to their elections to be regulated as such.

[12] The proposed rule allows for the value to be determined in accordance with U.S. GAAP and, if applicable, Section 2(a)(41) of the 1940 Act.

[13] Net realized and unrealized gains and losses are not currently included in the test under Rule 8b-2, but the Commission has proposed including such components to more fully capture the impact of the subject investment on the overall portfolio.

[14] While BDCs generally are required to provide two years of audited balance sheets and schedules of investments and three years for audited statements of operations, cash flows and changes in net assets, proposed Rule 6-11 (and the related amendment proposed to Form N-14) would require only a single year of financial statements be provided by BDCs.

[15] For example, if an investment company produces an audited schedule of investments following one or more contribution transactions, further financial statements for the corresponding acquired fund would no longer be required.

[16] A table of pro forma fees is currently required by Form N-14.