

# SEC Proposed Changes to Financial Disclosure Rules for Merger & Acquisition Transactions: First Analysis

A Lexis Practice Advisor® Practice Note by Anna T. Pinedo and Gonzalo Go, Mayer Brown LLP



Anna T. Pinedo  
Mayer Brown LLP

## Introduction

This article discusses the amendments proposed by the U.S. Securities and Exchange Commission (SEC) on May 3, 2019 in connection with financial statement disclosures on business acquisitions and dispositions as required by Regulation S-X's (17 C.F.R. §§ 210.1-01 - 12-29) Rule 3-05 (Financial Statements of Businesses Acquired or to be Acquired (Rule 3-05)), Rule 3-14 (Special Instructions for Real Estate Operations to be Acquired (Rule 3-14)), Article 11 on Pro Forma Financial Information (Article 11), and other related rules and forms. The SEC also proposed a new Rule 6-11 of Regulation S-X (Financial Statements of Funds Acquired or to be Acquired (Rule 6-11)) and an amendment to Form N-14 for financial reporting of acquisitions involving investment companies.

Through these proposed changes, the SEC aims to promote capital formation and to improve the quality of information made available to investors regarding the potential effects of significant acquisitions and dispositions. Some important proposed changes include: (i) revising the investment test and income test used in determining whether an acquisition or disposition is considered significant, thereby necessitating the inclusion of target financial statements; (ii) updating the required contents and period coverage of the acquired business' financial statements; and (iii) creating a new rule to address fund acquisitions by investment companies.

For a comprehensive list of Lexis Practice Advisor resources on the topics covered in this article, see [Financial Statements and Reporting Resource Kit](#).

## Background

When a business combination (other than a real estate operation) involving a registrant has occurred or is probable, the registrant is required pursuant to Rule 3-05 to provide separate audited annual, and unaudited interim historical financial statements of that business (Rule 3-05 Financial Statements) if the acquired business is considered significant. Currently, a registrant measures significance by applying the investment, asset and income tests provided in the "significant subsidiary" definition in Rule 1-02(w), substituting 20% for the significance threshold. The specified periods of financial information that a registrant must provide depends on the relative significance of the acquisition target to the registrant.

Pursuant to Rule 3-14, a registrant that has acquired a significant real estate operation (individually, or more than one in the aggregate) must file separate audited annual and unaudited interim abbreviated income statements (Rule 3-14 Financial Statements) with respect to such acquired operation. Only one year of Rule 3-14 Financial Statements is required if (i) the real estate operation is not acquired from a related party, (ii) the registrant discloses the material factors considered in assessing the real estate operation and (iii) the registrant indicates it is not aware of material factors that would cause the reported financial information not to be indicative of future operating results. If any of these conditions is not met, the registrant must file three years of Rule 3-14 Financial Statements.

In addition to filing the requisite target historical financial

statements, Article 11 also requires a registrant to file pro forma financial information reflecting the acquisition or disposition. This customarily includes a pro forma balance sheet and pro forma income statements. The pro forma financial information also reflects adjustments to show how the acquisition or disposition might have affected the financial statements had the transaction happened at an earlier time.

Rule 3-05 also applies to registrants that are registered investment companies and business development companies.

## Initial Guidance

Below is a summary of the principal changes proposed by the SEC.

### Financial Statements Submissions in General

A registrant may be required to file Rule 3-05 Financial Statements for up to a three-year period depending on the relative significance of the acquired or to-be acquired business. The SEC proposes: (i) to limit the historical financial statement requirement to up to two years, (ii) to dispense with the filing of a third year of Rule 3-05 Financial Statements for an acquisition exceeding 50% significance, and (iii) to require financial statements for the most recent interim period rather than any interim period for acquisitions that exceed the 20% but not the 40% significance threshold.

The SEC recognizes the difficulty in, and the costs associated with, preparing the required financial statements when a registrant acquires a business (as defined in Rule 11-01(d)), which does not constitute a separate entity, subsidiary or division (e.g., product line). It proposes to allow the registrant to provide abbreviated financial statements (i.e., audited financial statements of acquired assets and assumed liabilities, and statements of revenues and expenses exclusive of corporate overhead, interest and income tax expenses), provided the following conditions, among others, are met:

- The acquired business constitutes less than substantially all of the assets and liabilities of the seller and was not a separate entity, subsidiary, segment, or division during the periods for which the acquired business financial statements would be required.
- Separate financial statements for the acquired business have not previously been prepared.
- 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.

- The notes to the financial statements include certain additional disclosures as to the omitted expenses, cash flows, 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.

Current Rule 3-05 is silent on industry-specific disclosures for acquisitions involving significant oil and gas producing activities. The SEC proposes new Rule 3-05(f) requiring a registrant in the oil and gas producing sector to include in its Rule 3-05 Financial Statements the disclosures specified in FASB ASC Topic 932 Extractive Activities – Oil and Gas on an unaudited basis for each full year of operations presented for the acquired business. Rule 3-05 Financial Statements may be in the form of audited statements of revenues and expenses that exclude depletion, depreciation, and amortization expense, corporate overhead expense, income taxes, and interest expense that are not comparable to the proposed future operations if (i) substantially all of the revenues of the business are generated from oil and gas producing activities and (ii) the conditions of proposed Rule 3-05(e)(1) through (4) and (e)(6) are met.

The SEC proposes that Rule 3-05 Financial Statements no longer be required in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements for a complete fiscal year. This eliminates the current requirement to provide the Rule 3-05 Financial Statements when these have not been previously filed or have been previously filed but the acquired business is significant.

### Financial Statements of Real Estate Operations

The SEC proposes 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.”

The SEC found no unique industry considerations that necessitate a differentiated approach for real estate businesses. In order to standardize and simplify the requirements for acquired businesses while retaining the industry-specific disclosure necessary for investors to make informed investment decisions, the SEC proposes to align Rule 3-14 with Rule 3-05 as to, among other things, the significance thresholds, years of required financial statements for acquisitions from related parties, timing of filings and the omission of Rule 3-14 Financial Statements in registration statements and proxy statements once the acquired real estate operation is reflected in post-acquisition registrant financial statements that have been filed for a complete fiscal year.

## Financial Disclosures Specific to Investment Companies

An investment company registrant principally invests for capital appreciation and/or investment income and generally does not consolidate its controlled entities or use equity method accounting. Since at the moment there are no financial reporting rules or requirements specific to an investment company with respect to its acquisitions of investment companies and other types of funds (collectively, acquired funds), investment companies apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11.

The SEC proposes to: (i) 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, (ii) provide a significant subsidiary test specifically for investment companies, (iii) implement a new Rule 6-11 on fund acquisition financial reporting, (iv) replace the current pro forma financial information requirement for investment companies with the proposed Rule 6-11(d) requiring investment companies to provide supplemental financial information more relevant to investors and (v) amend Form N-14 to be consistent with the disclosures required in the proposed Rule 6-1,1 thereby ensuring that investors who acquire securities in a registered offering have the same disclosure that investors receive through financial statement disclosures in shareholder reports.

## Foreign Businesses

The SEC proposes to allow Rule 3-05 Financial Statements to be prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS) without reconciliation to US GAAP if the acquired business would qualify to use IFRS if it were a registrant. It also proposes to permit foreign private issuers that prepare their financial statements using IFRS to provide Rule 3-05 Financial Statements prepared using home country GAAP to be reconciled to IFRS rather than to US GAAP.

## Smaller Reporting Companies and Regulation A Issuers

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

## Looking Ahead

As part of the proposed revisions, the SEC has prepared a fact sheet summarizing the proposed amendments and the proposed rules, a copy of which is available at <http://bit.ly/2WCKvQw>. A copy of the proposing release is available at <http://bit.ly/2WtCmxP>. The SEC is seeking comments on its proposed revisions. Comments may be submitted to the SEC within a period of 60 days from the date of the proposing release's publication in the Federal Register (or until July 29, 2019).

---

**Anna T. Pinedo, partner, Mayer Brown LLP**

Anna Pinedo is a partner in Mayer Brown's New York office and a member of the Corporate & Securities practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the Euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

This document from Lexis Practice Advisor®, a comprehensive practical guidance resource providing insight from leading practitioners, is reproduced with the permission of LexisNexis®. Lexis Practice Advisor includes coverage of the topics critical to practicing attorneys. For more information or to sign up for a free trial, visit [lexisnexis.com/practice-advisor](http://lexisnexis.com/practice-advisor). Reproduction of this material, in any form, is specifically prohibited without written consent from LexisNexis.