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ACQUISITION AND DISPOSITION FINANCIALS UNDER REGULATION S-X 3-05 AND 3-14: SPOTLIGHT ON THE NEW ANALYSIS FOR REIT REGISTRANTS

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ACQUISITION AND DISPOSITION FINANCIALS UNDER REGULATION S-X 3-05 AND 3-14: SPOTLIGHT ON THE NEW ANALYSIS FOR REIT REGISTRANTS

On May 20, 2020, the Securities Exchange Commission ("**SEC**") formally adopted amendments to the Regulation S-X financial disclosure requirements for probable and completed acquisitions and dispositions of significant businesses under Rule 3-05 and real estate operations under Rule 3-14.[1] Amendments were also made to related rules and forms, including the pro forma financial statement rules under Article 11 and disclosure rules under Form 8-K. Importantly, the amended rules largely harmonize Rule 3-14 to Rule 3-05 where no unique industry considerations warrant a different treatment. These rule changes will be effective on January 1, 2021, but earlier voluntary compliance is permitted provided that the final amendments are applied in their entirety from the date of early compliance.[2]

"Although the focus is on SEC registrants organized as real estate investment trusts (**"REITs"**), the analysis applies to all SEC registrants."

This briefing focuses on how these amendments will impact the analysis that an SEC registrant (**"Acquiror"**) will face in connection with an acquisition of one or more businesses or real estate operations (**"Target"**), especially in the context of a securities offering. Although the focus is on SEC registrants organized as real estate investment trusts (**"REITs"**), the analysis applies to all SEC registrants. This briefing also discusses the analysis with respect to a disposition by SEC registrants of a significant business or real estate operation.

Exhibit A of this briefing provides a simplified flow chart to guide the Acquiror's analysis for acquisitions in the context of a securities offering. This briefing addresses both acquisitions and dispositions by discussing the following practical questions by reference to the amended rules:[3]

- Does Rule 3-05 or Rule 3-14 govern the analysis with respect to the Target's pre-acquisition historical financial statements?

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1. Amendments to Financial Disclosures about Acquired and Disposed Businesses, Release No. 33-10786 (May 20, 2020) (the "**Adopting Release**"). All references herein to rules and articles are to Regulation S-X unless otherwise specified.
2. The rule was originally proposed on May 3, 2019, as part of the SEC's continuing Disclosure Effectiveness Initiative for Regulations S-X and S-K. Regulation S-X had not undergone any significant amendments since a 1996 streamlining measure. In the six month comment period that followed, forty entities – representing a mix of law firms, accounting firms, investment funds and professional organizations – submitted written comments, which were generally supportive of the changes proposed by the SEC.
3. The Adopting Release also addresses, among other things, considerations relating to blind pool real estate offerings, foreign businesses, investment companies, oil and gas, and smaller reporting companies. This briefing does not address the foregoing items and is limited in the scope to the particular questions addressed herein.

- How does one determine whether a single acquisition is or "Related" (as defined herein) acquisitions are significant?
- If a single acquisition is or Related acquisitions are significant, what types of acquisition financial statements are required, what periods must they cover, and by when must they be filed?
- How does one determine whether "Unrelated" (as defined herein) acquisitions need to be aggregated and tested for aggregate significance?
- If there is aggregate significance for Unrelated acquisitions, what types of acquisition financial statements are required, what periods must they cover, and by when must they be filed?
- How long must Rule 3-05 and 3-14 Financial Statements be included or incorporated by reference in registration statements?
- What financial statements are required in connection with a significant disposition?
- What pro forma financial statements are required in connection with Rule 3-05 or 3-14 financial statements?

(1) Does Rule 3-05 or Rule 3-14 govern the analysis with respect to the Target's pre-acquisition historical financial statements?
Rule 3-05 applies broadly to any business[4] except a real estate operation,[5] for which Rule 3-14 applies.

The definition of the term "business" was not modified by the amended rules. The term "real estate operation" was previously defined only in the Division of Corporation Finance's Financial Reporting Manual (**"FRM"**).[6] Under the amended rules, the SEC sought to define a real estate operation in a manner consistent with pre-amendment practice and SEC staff interpretations and without changing the term's substance. Under Rule 3-14(a)(2), it is now defined as "a business that generates substantially all of its revenues through the leasing of real property." Within the real estate operation definition, the SEC is now using the term "business" in lieu of the prior term "properties" to address the fact that the acquisition of a real estate operation may made be through an entity holding real property under lease or by purchase of a direct interest in the real property.

Accordingly, those REITs, including mortgage REITs, that generate non-leasing revenues, such as nursing homes, hotels, motels, golf courses, auto dealerships, and equipment rental operations, will generally continue to be businesses subject to Rule 3-05.

Those REITs that generate substantially all of their revenue through the leasing of real property, such as through office, apartment, and industrial buildings, as well as self storage facilities, shopping centers and malls, will generally continue to be considered real estate operations subject to Rule 3-14.

4. For the definition of the term "business," see Rule 11-01(d).
5. See Rule 3-05(a)(4).
6. For a link to the pre-amendment FRM, see https://www.sec.gov/corpfin/cf-manual. We expect that the FRM will be updated in connection with the new amendments.

(2) How does one determine whether a single acquisition is or "Related" acquisitions are significant?

Consistent with the pre-amendment rules, businesses and real estate operations are deemed **"Related"** if (i) they are under common control or management; (ii) the acquisition of one business or real estate operation is conditional on the acquisition of each other business or real estate operation; or (iii) each acquisition is conditioned on a single common event. Related businesses and real estate operations are treated as if they were a single acquisition Target for purposes of measuring significance. Significance is measured by dividing certain of the Target's key metrics against the Acquiror's to produce a significance percentage.

For over 20 years, a single acquisition or group of Related acquisitions has been deemed "significant" under Rule 3-05 where the Target's applicable metrics exceed a minimum 20% threshold under any one of three different significance tests: (1) the investment test, (2) the asset test and (3) the income test.[7] Under Rule 3-14, a Target's significance has traditionally used a 10% significance threshold measured only by reference to the investment test.

One consequence of a finding that a single completed acquisition or series of Related acquisitions is significant is that historical and pro forma financial statements are required to be filed on Form 8-K seventy-one days after the initial Form 8-K related to the acquisition(s) is due. However, in the context of a securities offering, in certain cases, such financial statements may be required to be included or incorporated by reference into a registration statement for both **"Probable"**[8] and completed acquisitions on an expedited basis (as further described herein).

The amended rules preserve the substance of the existing asset test under Rule 3-05, but make important changes to the Rule 3-05 and 3-14 investment test and the Rule 3-05 income test (which is now an income and revenue test). Below is an explanation of certain of the more signficant changes to the investment and income tests:

(a) *Investment Test Changes*

> The new Rule 3-05 and 3-14 investment test requires the Acquiror's investments in the Target (e.g., purchase price) to be divided by the Acquiror's average aggregate worldwide market value of equity for the last five trading days of its most recently completed month before the announcement or agreement. Where the Acquiror has no market value, the denominator will instead be the Acquiror's consolidated total assets as of the most recently completed fiscal year. The significance threshold is 20%.

7. The significance tests in Rules 3-05 and 3-14 are derived from and cross-reference to the "significant subsidiary" definition in Rule 1-02(w), which was amended concurrently with Rules 3-05 and 3-14. Whether an acquisition is significant under Rules 3-05 and 3-14 is determined by applying the Rule 1-02(w) significance tests as modified by the thresholds set forth in Rules 3-05 and 3-14.

8. As defined in FRM Rule 2005.4, which was not modified by the Adopting Release, a probable acquisition or disposition is one where the registrant's financial statements alone would not provide adequate financial information to make an investment decision. For example, practitioners may view acquisitions and dispositions subject to a binding purchase agreement or letter of intent to be probable depending upon the specific facts and circumstances.

Two significant changes were made to the investment test. First, Rule 3-14's former 10% significance threshold was increased to 20%, which more closely aligns it with the investment test significance threshold under Rule 3-05. Second, in determining whether the numerical thresholds have been satisfied, the denominator under Rule 3-05 and Rule 3-14 was changed from a book value figure (total assets) to a market value figure (aggregate worldwide market value of all voting and non-voting equity shares). The SEC put this new denominator into place to enhance comparability between the numerator and the denominator. Under the new test, a market value numerator (purchase price)[9] is compared to the new market value denominator.

The new market value denominator will be calculated based on the average aggregate worldwide market value of the Acquiror's voting and non-voting equity shares for the last five trading days of the Acquiror's most recently completed month ending prior to the earlier of the Acquiror's announcement date or agreement date of the acquisition. However, to the extent the Acquiror does not have an aggregate worldwide market value (e.g., a non-reporting issuer conducting an IPO), the total assets denominator will still apply.[10] Notably, however, this test will only be used in an IPO for acquired businesses and real estate operations that are not designated as the registrant's accounting predecessor.[11]

When the total assets denominator applies, registrants are permitted to measure significance using filed pro forma financial information that reflects acquisitions made after the Acquiror's latest fiscal year-end if the registrant has filed its Rule 3-05 or Rule 3-14 Financial Statements and pro forma financial information.[12] The SEC previously required such filings to be made on Form 8-K, but they have removed this condition to extend the ability to use a pro forma denominator to non-reporting issuers who are preparing an initial registration statement.[13] The advantage of doing so is that Acquirors are able to calculate significance using a larger denominator than the one appearing in their annual historical financial statements.

While the increased significance threshold under Rule 3-14 may be designed to reduce compliance burdens for REIT registrants, under current market conditions where many REITs are highly leveraged and trading at a discount to book value, the new market value denominator may cause the 20% significance threshold to be triggered even where the prior 10% significance threshold would not have been.

Here is an example to illustrate the application of the investment test:

Imagine that an Acquiror expects to announce the purchase of a third-party Target in November 2020 for an expected purchase price of $200 million. As of December 31, 2019, the total assets of the Acquiror was $2.1 billion. Based on the last five trading days of October 2020, the average aggregate worldwide value of the Acquiror's voting and non-voting common stock was $1.0 billion (down 50% since year-end due to the impacts of the COVID-19 pandemic). Under these metrics, the acquisition would be insignificant at the 9.5% level under the pre-amendment tests ($200 million divided by $2.1 billion). However, if the new market-based denominator is used, the purchase price would be considered significant at the 20% level ($200 million divided by $1 billion).

9. For purposes of Rule 3-14 (but not Rule 3-05), the investment test numerator has also included any debt secured by the property that is assumed by the purchaser. Under amended Rule 3-14, such assumed debt is excluded from the numerator when using the aggregate worldwide market value denominator, but included when the denominator is based on total assets. Cf. FRM 2015.6 against FRM 2315.1.

10. For blind pool real estate offerings, an adapted denominator that includes the proceeds (net of commissions) in good faith expected to be raised in the first 12 months of a registered offering applies for purposes of the investment test when it is based on total assets. See 11-01(b)(4), 3-05(b)(3) and 3-14(b)(2)(iii). Since blind pool registrants generally do not initially own any real estate assets, in the absence of this accommodation, virtually all acquisitions in the early part of the distribution period would be deemed significant regardless of their size.

11. See *infra* note 21.

12. See 11-01(b)(3), Rule 3-05(b)(3) and Rule 3-14(b)(2)(iii). Such pro forma information may only give effect to the subsequently acquired business and transaction accounting adjustments. It 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. See 11-02(a)(6)(i). If a registrant has used pro forma amounts to determine significance, it must continue to use pro forma amounts to determine significance through the filing date of its next annual report on Form 10-K or Form 20-F.

13. In the case of an IPO, the Staff has permitted the use of pro forma information in limited circumstances in the past under Staff Accounting Bulletin No. 80, Application of Rule 3-05 in Initial Public Offerings ("**SAB 80**"). In the Adopting Release, the SEC observed that the SAB 80 method is similar to Rule 3-05, but the accommodations in SAB 80 are complex and seldom used by registrants.

(b) *Income Test Changes*

The new Rule 3-05 income and revenue test requires a determination of the lower of:

(a) the absolute value of the Acquiror's equity in Target's consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interests ("**pre-tax income**") divided by the absolute value of such pre-tax income of the Acquiror for the most recently completed fiscal year; and

(b) where the Acquiror and Target have had material revenue in the last two years, Acquiror's proportionate share of Target's consolidated total revenues from continuing operations (after intercompany eliminations) ("**total revenues**") divided by such total revenues of the Acquiror for the most recently completed full fiscal year.

The significance threshold is 20%.

The most significant change to the income test is adding a revenue test to mitigate anomalous results based only on pre-tax income, where registrants with marginal or break-even pre-tax income, which occurs often with REITs which have significant depreciation that reduces pre-tax income without affecting the operations of the REIT, have been required to file Rule 3-05 Financial Statements (as defined herein) for acquisitions that otherwise would not be considered material to investors. A revenue component was added because revenue generally has less variability than pre-tax income. For example, in addition to depreciation affecting REITs' pre-tax income, certain expenses, such as interest expense that will no longer be incurred or infrequent expenses, such as those for litigation or impairment, can affect pre-tax income, but not revenue.

Under the amended rules, an Acquiror will not breach the income test's minimum 20% significance threshold unless the Target meets both the pre-tax income component and the revenue component (when the revenue component applies). The Acquiror is then permitted to use the lower of the two components to determine the number of periods for which Rule 3-05 Financial Statements are required.

For these purposes, revenue is the Acquiror's proportionate share of the Target's consolidated total revenue from continuing operations (after intercompany eliminations) for the most recently completed fiscal year.

The revenue component does not apply if either the Acquiror or the Target did not have material revenue in each of the two most recently completed fiscal years.[14]

(3) If a single acquisition is or Related acquisitions are significant, what types of financial statements are required, what periods must they cover, and by when must they be filed?

Under the amended rules, much like the pre-amendment rules, the answer depends upon whether the acquisition is governed by Rule 3-05 or Rule 3-14, whether only the minimum threshold of significance was exceeded or whether a higher bar of significance was exceeded, and whether the acquisition is completed or Probable in the context of a securities offering or completed for purposes of Form 8-K. Each will be addressed in turn:

(a) *Rule 3-05 versus Rule 3-14 Financial Statements*

For acquisitions governed by Rule 3-05, the Acquiror must file with the SEC the applicable Target's full set of standalone audited[15] annual and (where applicable)[16] unaudited interim pre-acquisition financial statements required under Regulation S-X for the periods set forth in Rule 3-05 (**"Rule 3-05 Financial Statements"**).[17] This will include balance sheets, income statements and cash flow statements.[18]

By contrast, for acquisitions governed by Rule 3-14, only the filing of an abbreviated audited annual income statement and (where applicable)[19] unaudited interim income

14. Where the revenue component does not apply, if the Acquiror's pre-tax income 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 (the "**Five-Year Average**"), the SEC has also clarified that the Five-Year Average may be used as the Acquiror's denominator for purposes of the pre-tax income test in lieu of the Acquiror's pre-tax income for the most recently completed fiscal year. See 1-02(w)(1)(iii)(B)(2).

15. The amended rules clarify that the auditor of Rule 3-05 Financial Statements and Rule 3-14 Financial Statements must be independent under Rule 2-01. However, if the Target is not an SEC registrant, the SEC staff has acknowledged that an auditor may follow AICPA auditing and independence standards but also may elect to perform the audit under PCAOB auditing standards.

16. Interim financial statements will only be required to cover quarterly periods in registration statements since the end of the most recent fiscal year end to the extent that the date used in the most recent annual or interim financial statements would otherwise be more than 130 days old for accelerated and large accelerated filers and 135 days old for all other registrants. See Rule 3-12(a) and Rule 3-12(g).

17. Rule 3-05(a) requires, subject to the existence of certain conditions, financial statements "prepared and audited in accordance with this regulation" for the periods specified in Rule 3-05(b).

18. Under Rule 3-05, the SEC has formalized certain ad hoc exceptions where abbreviated financial statements of the Target are permitted instead of full set financial statements. For example, such financial statements are allowed for a business segment or a component of an entity that qualifies as a "business" but was not treated as a separate entity, subsidiary or division of the seller. The requirement to produce separate, audited Rule 3-05 Financial Statements under such circumstances could be burdensome if not prohibitive as these businesses, representing only a small portion of the selling entity, may not have separate financial statements or maintain the separate and distinct accounts necessary to prepare Rule 3-05 Financial Statements. Furthermore, making the 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. In light of these difficulties and subject to certain conditions, the SEC has permitted and will continue to permit Acquirors to provide abbreviated financial statements of the Target in the form of statements of assets acquired and liabilities assumed and statements of revenues and expenses.

19. See *supra* note 16.

statement is required, which income statements are typically referred to as statements of revenue and certain expenses (**"Rule 3-14 Financial Statements"**). However, the notes to the Rule 3-14 Financial Statements must include certain required disclosures.[20]

Except for certain aggregated Unrelated acquisitions as defined and described herein, pro forma financial information complying with Article 11 must also be included whenever historical financial statements of the Target are required.

Notably, full financial statements for predecessor businesses in initial registration statements will continue to be required, rather than Rule 3-05 or Rule 3-14 Financial Statements.[21]

(b) *Number of Periods Based Upon Level of Significance Exceeded*

Under the pre-amendment framework, Rule 3-05 Financial Statements were required for the most recent fiscal year and (where applicable) any interim periods if any of the Rule 3-05 significance tests exceeded 20%, but none exceeded 40%, a second year was required if any test exceeded 40%, but none exceeded 50%, and a third year was required if any of the tests exceeded 50%.

The final amendments eliminate the threshold between 40% and 50%. Accordingly, there is no longer a requirement for a third year of Rule 3-05 Financial Statements. The SEC's rationale for this was that the third year of Rule 3-05 Financial Statements was cumbersome and costly and less likely to be indicative of the current financial condition, changes in financial condition and results of operations of the acquired business.[22]

Under amended Rule 3-05, the two most recent fiscal years and "any" interim periods are required for significance above 40% and the most recent fiscal year and "most recent" interim periods are required for significance between 20% and 40%. The "most recent" interim period requirement is a new rule that eliminates the need to provide a comparative interim period when only one year of audited financial statements is required.

Under Rule 3-14, which does not have a 40% threshold, only the most recent fiscal year and most recent interim period (where applicable) is required for significance above 20%. This modification reflects the elimination of the former requirement in Rule 3-14 (which did not apply to Rule 3-05) to provide three years of financial statements

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20. See Rule 3-14(c) and Rule 3-14(f).

21. The SEC has advised that "It is common for transactions in initial registration statements in the real estate industry to involve the combination of multiple entities with related or common ownership. In those circumstances, certain acquired entities may be designated as a predecessor of the registrant. For purposes of financial statements, an acquired business is designated as a predecessor when a registrant succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired. See the definition of "predecessor" in Securities Act Rule 405. Financial statements specified in Rules 3-01 and 3-02 are required for acquisitions of a predecessor, including those from related parties, rather than Rule 3-05 or Rule 3-14 Financial Statements. These amendments will not affect those requirements." See Adopting Release, footnote 227.

22. Notably, however, under both Rule 3-05 and 3-14, where the Acquiror is registering an offering of securites to the security holders of the Target, three years of historical financial statements could be required in a proxy statement or registration statement on Form S-4 or Form F-4. See Rule 3-05(b)(1) and Rule 3-14(b)(1).

for significant acquisitions from related parties. In addition, the SEC has clarified that financial statements of lessees and guarantors of triple net leases with a single significant tenant will no longer be required.[23]

(c) *Grace Period and Probable Acquisitions in the Context of a Securities Offering*

Under the amended rules,[24] in the context of a securities offering, Rule 3-05 and 3-14 Financial Statements and pro forma financial information for completed acquisitions and Probable acquisitions that exceed 50% significance must be included or incorporated by reference into a registration statement.[25]

However, registration statements (not subject to the blank check offering rules) may omit such financial statements if the Target does not exceed any of the conditions of significance at the 50% level, and either (A) the acquisition is merely Probable; or (B) the date of the final prospectus supplement relating to an offering is no more than 74 days after consummation of the acquisition (the "**Grace Period**").

In addition, as further described below, Rule 3-05 Financial Statements or Rule 3-14 Financial Statements for completed acquisitions exceeding 20% (but not 50%) significance where such financial statements have not yet been filed due to the Grace Period ("**Grace Period Acquisitions**") will be required to be included or incorporated by reference in a registration statement for a securities offering if such acquisitions, together with Individually Insignificant Acquisitions (as defined herein) and Probable acquisitions that are individually less than 50% significant, exceed 50% significance in the aggregate.[26]

Even where financial statements for Grace Period Acquisitions and Probable acquisitions are not technically required to be included or incorporated by reference into a registration statement, the issuer and the underwriters may decide on a case by case basis to include or incorporate by reference the financial statements themselves or narrative disclosure about the acquisitions, including certain highlights from the financial statements. Such a decision will be dictated by either marketing considerations or a view that the acquisition is material from a disclosure perspective.

Whether technically required or not, inclusion or incorporation by reference of such financial statements should be decided early on in a deal as it may delay the timing of an offering.

(d) *Form 8-K*

Consistent with pre-amendment practice, amended Item 2.01 of Form 8-K requires registrants to disclose the closed (not Probable) acquisition of a significant amount of assets and Item 9.01 of Form 8-K requires the registrant to file Rule 3-05 or Rule 3-14 Financial Statements and related pro forma financial information for significant businesses and real estate operations.

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23. See the Adopting Release pages 82-83, footnote 219. Triple net leases typically require the lessee to pay costs normally associated with ownership of the property, such as property taxes, insurance, utilities, and maintenance costs. Under existing practice pursuant to FRM Rule 2340, registrants often provide audited financial statements of the lessee or guarantor of the lease, instead of the Rule 3-14 Financial Statements of the real estate operation, when the lessee is considered significant. The Adopting Release does not differentiate this type of acquisition or specify alternatives to Rule 3-14 for this type of acquisition.

24. Rule 3-05(b)(4), Rule 3-14(b)(3) and Rule 11-01(c)

25. See Rule 3-05(b)(4) and Rule 3-05(b)(2)(iii) and 3-14(b)(3) and Rule 3-14(b)(2)(iii)

26. See *infra* note 28.

An acquisition is deemed to involve a "significant amount of assets" in two pertinent cases:

- if the registrant's and its other subsidiaries' equity in the net book value of such assets or the amount received for the assets upon such disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries; or
- if it involved a business (including a real estate operation) that is significant at the 20% significance threshold under the applicable significant tests described in this briefing.

Under the pre-amendment rules, the filing of Rule 3-14 Financial Statements and related pro forma financial information was effectively triggered by the same 10% total asset threshold under both of the above tests. Under the revised rules, as part of the effort to align Rules 3-14 and 3-05, the filing of Rule 3-05 and 3-14 Financial Statements and related pro forma financial information is now only triggered at the 20% significance level under the second bullet point above. Under the first bullet point above, narrative disclosure of the acquisition continues to be required under Item 2.01 of Form 8-K, but historical and pro forma financial statements are not required to be filed under Item 9.01 of Form 8-K.[27]

Where a Target's Rule 3-05 or Rule 3-14 Financial Statements and the Acquiror's pro forma financial statements are required, they must be filed with the initial report on Form 8-K or by amendment not later than 71 calendar days after the date that the initial report on Form 8-K was due to be filed.

(4) How does one determine whether "Unrelated" acquisitions need to be aggregated and tested for aggregate significance?

Under pre-amendment Rule 3-05, to the extent completed acquisitions of "individually insignificant businesses"[28] exceeded 50% significance in the aggregate under any of the tests, the Acquiror was required to file Rule 3-05 Financial Statements and related pro forma financial statements to cover a substantial majority of such Targets.

Under the pre-amendment Rule 3-14 guidance, to the extent completed acquisitions of individually insignificant real estate operations (i.e., those that are less than 10% significant exceeded 10% significance in the aggregate), the Acquiror was required to file Rule 3-14 Financial Statements and related pro forma financial statements to cover each acquisition that was 5% or more significant and a substantial majority of the rest of the group.

The SEC noted that, under the pre-amendment guidance, Acquirors have often provided Rule 3-05 and 3-14 Financial Statements for Targets that were individually not material to the Acquiror and pro forma financial information that did not fully depict the aggregate effect of the Targets.

27. See Item 9.01(b) of Form 8-K and 11-01(c).

28. Since 1996, the SEC staff has used the term "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 because of the 75-day filing period. See Adopting Release at page 79. In this briefing, we refer to these three categories as "**Unrelated**" instead of individually insignificant given that categories (b) and (c) include business which may exceed the 20% significance threshold.

The amendments are meant to address these anomalies and to align the 50% aggregate impact significance threshold in Rule 3-05 with Rule 3-14.

Under the amended rules, the following categories of **"Unrelated"** acquisitions are grouped together and tested for aggregate significance at the 50% threshold[29]:

- completed acquisitions whose significance does not exceed 20% ("**Individually Insignificant Acquisitions**");
- Probable acquisitions whose significance does not exceed 50%; and
- Grace Period Acquisitions.

Acquirors are required to aggregate both Rule 3-05 businesses and Rule 3-14 real estate operations (where both are present) in the investment test numerator.[30]

(5) If there is aggregate significance for Unrelated acquisitions, what types of financial statements are required, what periods must they cover, and by when must they be filed?

Under the amended rules, in the context of a securities offering, issuers will be required to provide pro forma financial information depicting the aggregate impact, in all material respects, of all Unrelated acquisistions that exceed 50% in the aggregate for any condition. Rule 3-05 and Rule 3-14 Financial Statements for Grace Period Acquisitions would also need to be filed without the benefit of the Grace Period.

However, filing will no longer will be required for other historical financial statements. For Individually Insignificant Acquisitions, Rule 3-05 and Rule 3-14 Financial Statements will no longer be required to be filed at all, which will mitigate the problem under the previous rules of immaterial historical financial statements.[31]

With respect to any Probable acquisition or group of related Probable acquisitions whose significance does not exceed 50% in the aggregate, Rule 3-05 and Rule 3-14 Financial Statements will not be required.

However, for both Individually Insignificant Acquisitions and Probable Acquisitions, Acquirors will still have to negotiate the timely provision of historical balance sheets and income statement information. Although such historical financial statements are not required to be filed, they are necessary to obtain in order to present the pro forma financial information that is required to be filed.[32] This requirement is intended to mitigate the problem of incomplete pro forma information under the pre-amendment rules.

"However, for both Individually Insignificant Acquisitions and Probable Acquisitions, Acquirors will still have to negotiate the timely provision of historical balance sheets and income statement information. Although such historical financial statements are not required to be filed, they are necessary to obtain in order to present the pro forma financial information that is required to be filed."

For Grace Period Acquisitions, outside of the context of a securities offering, no Rule 3-05 or Rule 3-14 Financial Statements would be required until the Grace Period expires. In the context of a securities offering, however, if a Grace Period Acquisition that is less than 50% significant gets aggregated with Individually Insignificant Acquisitions and/or Probable Acquisitions and the 50% threshold is exceeded in the aggregate, the Rule 3-05 or Rule 3-14 Financial Statements for these Grace Period

29. See *supra* note 28.

30. See Adopting Release page 80.

31. See Rule 3-05(b)(2)(iv)(B) and Rule 3-14(b)(2)(C)(2)

32. See Rule 11-01(c), Rule 3-05(b)(2)(iv)(A) and Rule 3-14(b)(2)(C)(1)

Acquisitions will be required to be included or incorporated by reference into the registration statement for the securities offering.

Under amended Form 8-K, the aggregate impact of Unrelated acquired businesses and real estate operations are not required to be reported pursuant to Item 2.01 or Item 9.01. Only financial statements for Grace Period Acquisitions must be disclosed by the expiration of the Grace Period. Pro forma financial statements under Form 8-K are only required for transactions required to be described in answer to Item 2.01 of Form 8-K and required under Article 11.

Under the amended rules, any Rule 3-05 or Rule 3-14 Financial Statements for a Grace Period Acquisition must cover, at a minimum, the most recent fiscal year and (where applicable) the most recent interim period specified.[33]

(6) How long must Rule 3-05 and 3-14 Financial Statements be included or incorporated by reference in Registration Statements?

Under pre-amendment practice under Rule 3-14, financial statements for acquired properties that have been included in the registrant's audited financial statements for one fiscal year (e.g., properties acquired during the earliest two of the three years presented in the financial statements) were required to be included or incorporated by reference in a registration statement until the property had been consolidated for all three years for which the registrant's financial statements are presented.[34]

By contrast, under Rule 3-05, registrants were not generally required to continue including or incorporating by reference audited financial statements of a Target once the Target had been reflected in the Acquiror's financial statements for one fiscal year (unless such financial statements had not been previously filed or the acquired business was of major significance at the 80% significance level under any of the significance tests). 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.

Under the amended rules, as part of the effort to harmonize Rule 3-14 and Rule 3-05, the SEC is no longer requiring Rule 3-14 Financial Statements in registration statements once the acquired real estate operation is reflected in filed post-acquisition audited registrant financial statements for nine months.[35]

This requirement aligns Rule 3-14 with the length of time for inclusion or incorporation by reference of Rule 3-05 Financial Statements for acquisitions between 20% and 40% significance. Notably, a Rule 3-05 acquisition above 40% significance must be included or incorporated by reference until the business is reflected in filed post-acquisition audited registrant financial statements for one year (rather than nine months).[36,37]

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33. See Rule 3-05(b)(2)(iv)(B) and Rule 3-14(b)(2)(C)(2)
34. See SEC Regulations Committee, March 31, 2015 Joint Meeting with SEC Staff, SEC Offices Washington D.C. at page 5.
35. See Rule 3-14(b)(3)(iii) and Rule 306.
36. See Rule 3-05(b)(4)(iii) and Rule 306.
37. The SEC notes that in unusual circumstances where such pre-acquisition financial statements are necessary for the protection of investors even though the Target financial statements have been included or incorporated by reference in the Acquiror's post-acquisition results for a complete fiscal year, Rule 3-13 permits the SEC staff by delegated authority to require the filing of the pre-acquisition financial statements.

(7) What financial statements are required in connection with a significant disposition?

For dispositions, unlike acquisitions, Rules 3-05 and 3-14 do not apply. Accordingly, there is no requirement to file separate historical pre-disposition financial statements for the disposed business or real estate operation under any circumstances.

Consistent with pre-amendment practice, amended Item 2.01 of Form 8-K requires registrants to disclose the closed (not Probable) disposition of a significant amount of assets and Item 9.01(b) of Form 8-K requires the registrant to file pro forma financial information for any disposition required to be described in answer in Item 2.01 of Form 8-K for which pro forma financial information is required pursuant to Article 11.

Much like the amendments made in the acquisition context, a disposition under the amended rules is deemed to involve a "significant amount of assets" and hence will require narrative disclosure:

- if the registrant's and its other subsidiaries' equity in the net book value of such assets or the amount received for the assets upon such disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries; or
- if it involved a business (including a real estate operation) that is significant at the 20% significance threshold as defined in Rule 11-01(b).[38]

Consistent with pre-amendment practice, Rule 11-01(a) only requires pro forma financial information to be filed in connection with a disposition in two circumstances[39]:

- The 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 has occurred or is probable and such disposition is not fully reflected in the financial statements of the registrant included in the filing; and
- Consummation of other transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors.

In light of these requirements, registrants may conclude, under certain circumstances, that a sale of assets that breaches the 10% of total assets test requires narrative disclosure under Item 2.01 of Form 8-K, but may not amount to the disposition of a significant portion of a business or otherwise be material for purposes of filing pro forma financial statements.

The Adopting Release did not address whether a diposition of a significant business (i.e., one exceeding 20% under the applicable significance tests) is tantamount to the disposition of a significant portion of a business. However, if 100% of a business is sold and such business is significant, it seems clear that pro forma financial statements will be required to be filed under Rule 11-01(a)(4) and (a)(8). The SEC stated that they 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.

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38. See Rule 11-01(b)(1). Under the pre-amendment rules a 10% significance threshold was used to measure significant dispositions. For dispositions of real estate operations (unlike acquisitions), the SEC did not adopt the modification to 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.

39. See 11-01(a)(4) and 11-01(a)(8).

Questions about the need to file pro forma financial statements may arise, however, where a percentage that is less than 100% of a significant business is sold and where a significant portion of an insignificant business is sold. The answer on whether pro forma financial information must be filed will depend upon the specific facts and circumstances.

In the context of a securities offering, even though Form 8-K would not require the filing of pro forma financial statements for a probable disposition, practitioners will also need to consider whether the probable disposition of a significant business must included or incorporated by reference into the registration statement given that Rule 11-01(a)(4) includes a filing requirement for both completed and probable dispositions.

Unlike with acquisitions, where the filing of historical and pro forma financial statements benefit from a Grace Period, when pro forma financial statements are required to be filed with a Form 8-K, they must be filed within four business days.[40]

(8) What pro forma financial statements are required in connection with Rule 3-05 or 3-14 financial statements?

Pro forma financial information described in Article 11 of Reg S-X must accompany Rule 3-05 and Rule 3-14 Financial Statements and must be filed on their own as described in this briefing in certain cases involving dispositions and aggregate significance for Unrelated Acquisitions. Typically, that pro forma financial information includes the most recent balance sheet and most recent annual and interim period income statements. Pro forma information combines the historical financial statements of the registrant and the Target and is adjusted for certain items if specified criteria are met. As discussed above, under the amended rules, pro forma financial information for an acquired or disposed business is required at or above the 20% significance threshold.

Amended Article 11 introduces new adjustment criteria and presentation requirements for pro forma financial information. The new pro forma adjustment criteria are divided into three categories: (i) transaction accounting adjustments; (ii) autonomous entity adjustments; and (iii) management adjustments.

The first two categories of adjustments – transaction accounting and autonomous entity adjustments – will be required in the presentation of pro forma financial information. Management adjustments, however, are optional (although the SEC encourages registrants to consider including them).

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. Registrants will be required to depict (1) in the pro forma condensed balance sheet, the accounting for the transaction required by US GAAP or IFRS, as applicable 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.

40. See Form 8-K Item 9.01(b)(2) (explaining that the 71 calendar day grace period in Item 9.01(a)(3) also applies to pro forma financial information relative to the acquired business, but is silent on its application to a disposed business). See FRM Section 2024.5 ("Pro forma financial statements depicting a significant disposition are ordinarily required to be filed within 4 business days of the disposition").

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. This would include, for instance, when the registrant operates as a subsidiary of another entity and files a registration statement in connection with an IPO, and presentation of pro forma financial information is necessary to reflect the operations and financial position of the registrant as an autonomous 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.

The conditions for presenting management's adjustments are as follows:

- There must be 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 of the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented.
- When synergies are presented, any related dis-synergies must also be presented.

The explanatory notes containing management's adjustments must also include the following:

- disclosure of the basis for and material limitations of each of the management's adjustments, 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.

EXHIBIT A

3-05 AND 3-14 ANALYSIS FLOW CHART

When are rule 3-05 or 3-14 financial statements and related pro formas required for a recent acquisition in the context of a securities offering?

(1) Does Rule 3-05 or 3-14 govern?

Is the acquiree (the **"Target"**) a ***"Business"*** under 11-01(d) or a ***"Real Estate Operation"*** under 3-14(a)(2)?	If yes to either, 3-05 applies to "Businesses" and 3-14 applies to Real Estate Operations.
Is the acquiror selling securities to the Target's shareholders (e.g., on Form S-4/F-4 or a merger proxy statement)?	If yes, see 3-05(b)(1) and 3-14(b)(1).

(2) Does significance for a single Target or "Related" Targets exceed 20% under any of the applicable tests below? Does aggregate significance for "Unrelated" Targets exceed 50%? *See 1-02(w)(1), 3-05(b)(2), and 3-14(b)(2).*

Definitions	Targets are deemed **"Related"** and grouped for testing at the 20% threshold if (i) they are under common control or management; (ii) the acquisition of one Target is conditional on the acquisition of each other Target; or (iii) each acquisition is conditioned on a single common event. The following groups of Targets are deemed **"Unrelated"** and grouped for testing at the 50% threshold: (i) completed acquisitions not exceeding 20% significance (**"Individually Insignificant Acquisitions"**); (ii) completed acquisitions exceeding 20% (but not 50%) where financial statements are not yet filed due to the 74-day grace period under 3-05 or 3-14 (**"Grace Period Acquisitions"**); and (iii) **"Probable"** acquisitions (e.g., one under contract or LOI but not completed) not exceeding 50%.
Investment Test (applies to both 3-05 and 3-14)	***Equals*** acquiror's investments in Target (e.g., purchase price) ***divided by*** acquiror's average aggregate worldwide market value of equity for the last five trading days of its most recently completed month before the announcement or agreement. Where the acquiror has no market value, use the denominator in the Asset Test below instead. For **blind pool real estate offerings**, an adapted denominator applies for purposes of the investment test when it is based on total assets.
Asset Test (applies to 3-05 only)	***Equals*** acquiror's proportionate share of Target's consolidated total assets (after intercompany eliminations) ***divided by*** acquiror's consolidated total assets as of the most recently completed fiscal year. A larger **pro forma denominator** is permitted in some cases to take into account other recent acquisitions. See 11-01(b)(3).
Income and Revenue Test (applies to 3-05 only)	***Equals*** the lower of: (a) the absolute value of the Acquiror's equity in Target's consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interests (**"pre-tax income"**) ***divided by*** the absolute value of such pre-tax income of the Acquiror for the most recently completed fiscal year; and (b) where the Acquiror and Target have had material revenue in the last two years, Acquiror's proportionate share of Target's consolidated total revenues from continuing operations (after intercompany eliminations) (***"total revenues"***) ***divided by*** such total revenues of the Acquiror for the most recently completed full fiscal year. A larger **pro forma denominator** is permitted in some cases to take into account other recent acquisitions. In some cases, the pre-tax income denominator can use a five-year average. See 1-02(w)(1)(iii)(B)(2).

(3) ***If there is "significance," the following Target financial statements will be required to be included or incorporated by reference into a Registration Statement[1]:*** *See 3-05(b)(2) and (4) and 3-14(b)(2) and (3).*

Completed Acquisition of **Related Real Estate Operations** deemed significant above **20%**	Until the acquisition has been reflected in the acquiror's audited financial statements for **nine months**: • Audited abbreviated income statement (i.e. statement of revenue of expense) of the Target for the ***most recent fiscal year*** (**"3-14 Financial Statements"**). • Unaudited interim 3-14 Financial Statements may also be required for the stub period • Related Pro Forma Financial statements complying with Article 11 (**"Pro Forma Financial Statements"**)
Completed Acquisition of **Related Businesses** deemed significant between **20% and 40%**	Until the acquisition has been reflected in the acquiror's audited financial statements for **nine months**: • Audited financial statements of the Target for the most ***recent fiscal year***, including balance sheet, income statement and cash flow statement (**"3-05 Financial Statements"**). • Unaudited interim 3-05 Financial Statements may also be required for the stub period • Pro Forma Financial Statements
Completed Acquisition of **Related Businesses** deemed significant above **40%**	Until the acquisition has been reflected in the acquiror's audited financial statements for **one year**: • Audited 3-05 Financial Statements for the most ***recent two fiscal years*** • Unaudited interim 3-05 Financial Statements may also be required for the stub period (and comparable period from the prior year) • Pro Forma Financial Statements
Probable and Completed Acquisitions of **Related Businesses** or **Real Estate Operations** deemed significant **above 50%**	Until the acquisition has been reflected in the acquiror's audited financial statements for one year (in the case of 3-05) or **nine months** (in the case of 3-14): • Audited 3-05 Financial Statements for the most ***recent two fiscal years*** or 3-14 Financial Statements for the most ***recent fiscal year***. • Unaudited interim 3-05 or 3-14 Financial Statements may also be required for the stub period • Pro Forma Financial Statements
Probable and Completed Acquisitions of **Unrelated Businesses** and **Real Estate Operations** deemed significant on an aggregate basis **above 50%**	• For Individually Insignificant Acquisitions and Probable Acquisitions, no 3-05 or 3-14 Financial Statements are required. • Until the acquisitions have been reflected in the acquiror's audited financial statements for **one year**: - For Grace Period Acquisitions, either 3-05 or 3-14 Financial Statements are required for the most ***recent fiscal year*** and unaudited interim 3-05 or 3-14 Financial Statements may also be required for the stub period - Pro Forma Financial Statements depicting the aggregate impact, in all material respects, of all such Individually Insignificant Acquisitions, Grace Period Acquisitions and Probable Acquisitions are required (even where 3-05 or 3-14 Financial Statements are not required to be filed).
Other	• Although certain acquisitions may not technically require filing or disclosure, deal teams may choose to file 3-05 or 3-14 Financial Statements and related Pro Forma Financial Statements or provide narrative disclosure on a case by case basis due to marketing and/or disclosure considerations.

1. Outside of the context a securities offering, Rule 3-05 and 3-14 financial statements that exceed the applicable 20% thresholds will need to be filed in a Form 8-K amendment seventy-one days after the initial Form 8-K is due. Form 8-K does not require the filing of financial statements for Individually Insignificant Acquisitions, Probable acquisitions or the aggregate impact of Unrelated acquisitions.

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