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SEC/CORPORATE

SEC-Proposed Amendments to Financial Disclosures for Acquisitions and Dispositions of Businesses

As a result of the Securities and Exchange Commission's 2015 request for comments on Regulation S-X, the SEC recently proposed amendments (the Proposal) to improve the financial disclosures provided to investors concerning an acquisition or disposition of a business. The Proposal is designed to reduce complexity and compliance costs and facilitate more timely access to capital for those complying with such rules.

The following are some key elements of the Proposal:

- **Updates to the Significance Tests**. Requirements in Rules 3-05 and 1-02(w) of Regulation S-X would be amended to modify the investment and income tests used to determine the significance of a business acquisition or disposition.
    - The investment test currently requires a comparison of an acquiring company's investment in an acquired business to the acquiring company's total assets. The Proposal would instead require a comparison of an acquiring company's investment in an acquired business to "the aggregate worldwide market value of the [acquiring company]'s voting and non-voting common equity." The market value would be determined on the last business day of the acquiring company's most recent fiscal year prior to the acquisition. If such market value were not available, the current test based upon the acquiring company's total assets would apply.
    - The income test currently requires a comparison of an acquiring company's and acquired business' income from continuing operations before income taxes. The Proposal would instead use income from continuing operations *after* income taxes and add a comparison of an acquiring company's and acquired business' consolidated total revenue. Where an acquiring company with its consolidated subsidiaries and the tested subsidiary both have recurring annual revenue, both tests would have to be met to establish significance. If there were no recurring annual revenue for either company, only the income test would apply.
    - The SEC additionally proposed further changes intended to simplify and clarify the investment and income tests.
- **Updates to Financial Statement Requirements**. Rule 3-05 of Regulation S-X would be amended to limit the number of years of separate audited annual and unaudited interim pre-acquisition financial statements of a business (Financial Statements) required to be disclosed and to clarify when Financial Statements are required.
    - Rule 3-05 of Regulation S-X currently requires the disclosure of up to three fiscal years of audited Financial Statements based on the relative significance of a transaction. The Proposal would reduce this requirement to a maximum of two fiscal years.
    - Rule 3-05 of Regulation S-X currently requires an acquiring company to file Financial Statements for the acquisition of a component of an entity, such as a product line contained in more than one subsidiary (referred to as a carve-out transaction). The Proposal would allow an acquiring company to provide audited financial statements of acquired assets and assumed liabilities, and statements of revenues and expenses (excluding corporate overhead, interest and income tax) if the acquired business meets specified requirements including that "the business constitutes less than substantially all of the assets and liabilities of the seller and was not a separate entity, subsidiary, segment, or division during the periods for which the acquired business financial statements would be required."

- Rule 3-05 of Regulation S-X currently requires the disclosure of Financial Statements when they have not been previously filed, even if included in post-acquisition audited results, or when the acquired business is of "major significance" to the acquiring company. The Proposal would no longer require disclosure of Financial Statements for an acquired business in registration statements and proxy statements once post-acquisition financial statements reflect the acquired business for a complete fiscal year; and it would eliminate the "major significance" exception.
- Under Rule 3-05 of Regulation S-X, if the aggregate impact of "individually insignificant businesses" exceeds 50 percent, acquiring companies are currently required to provide 1) audited historical pre-acquisition financial statements covering at least the substantial majority of acquired businesses; and 2) related pro forma financial information. The Proposal would instead require acquiring companies to provide pro forma financial information "depicting the aggregate effects of all such businesses in all material respects" and historical pre-acquisition financial statements only for businesses whose individual significance exceeds 20 percent but for which financial statements are not yet required.

- **Updates to Pro Forma Financial Statement Requirements**. Requirements in Article 11 of Regulation S-X would be amended to adjust the criteria and presentation rules.
  - For the presentation of pro forma condensed statements of comprehensive income, Rule 11-02 of Regulation S-X currently only allows adjustments that are 1) directly attributable to the transaction; 2) expected to have a continuing impact on the acquiring company; and 3) factually supportable. The Proposal would replace the existing pro forma adjustment criteria for both the statement of comprehensive income and balance sheet with simpler requirements to exhibit, in separate columns, the following:
    - adjustments for transaction accounting; and
    - adjustments for synergies and other transaction effects that are reasonably estimable "such as closing facilities, discontinuing product lines, terminating employees and executing new or modifying existing agreements."
  - The Proposal would also mandate further explanatory notes concerning the new adjustment criteria.
  - Rule 11-01(b) of Regulation S-X currently requires pro forma financial information if the disposition of a business meets a 10percent significance threshold rather than the 20 percent threshold used for business acquisitions under Rules 3-05 and 11-01(b). The Proposal would raise the Rule 11-01(b) threshold to 20 percent and conform the tests used to determine the significance of a disposed business to those used for an acquired business.
  - Rules 3-05 and 3-14 of Regulation S-X currently do not allow a company completing a disposition or filing an initial registration statement to determine the significance of a transaction using pro forma, rather than historical, financial information. However, this is permitted for an acquiring company which completed an acquisition subsequent to the latest fiscal year-end and filed Financial Statements and pro forma financial information on Form 8-K. The Proposal would permit companies to measure significance using filed pro forma financial information that only includes significant acquisitions and dispositions completed after the end of the latest fiscal year-end for all filings requiring 3-05 or 3-14 Financial Statements, subject to listed filing requirements.
- **Updates Based on IFRS-IASB Accounting Standards**. Regulation S-X does not currently permit the financial statements of an acquired business, which is not a "foreign business," to be prepared using International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB). The Proposal would permit the application of IFRS-IASB without US Generally Accepted Accounting Principles (GAAP) reconciliation if the acquired business would qualify to use the standards as an SEC registrant. Additionally, foreign private issuers could reconcile using IFRS-IASB accounting standards rather than US GAAP for Financial Statements prepared using home country GAAP.
- **Updates for Significant Oil- and Gas-Producing Activities**. Rule 3-05 of Regulation S-X does not currently detail industry-specific disclosures for a significant acquired business that includes "significant oil- and gas-producing activities." The Proposal would codify the reporting practices in the Financial Accounting Standards Board supplemental disclosures and allow for audited statements of revenues and expenses (excluding depletion, depreciation, amortization, corporate overhead, income taxes and interest expense not comparable to proposed future operations) rather than Financial Statements.
- **Other Updates**. The Proposal also includes further updates for small reporting companies, real estate operations and investment companies under Regulation S-X.

The SEC is soliciting comments on the Proposal for a period of 60 days after publication in the *Federal Register*.

The Proposal is available here.

CFTC

CFTC Division of Enforcement Issues Public Enforcement Manual

On May 8, the Division of Enforcement (the "Division") of the Commodity Futures Trading Commission issued its first public enforcement manual (the "Enforcement Manual"). The Enforcement Manual explains the roles of the CFTC and Division generally, and outlines certain general policies and procedures that guide the Division in its investigation and prosecution of violations of the Commodity Exchange Act (CEA) and CFTC Regulations.

In addition to its serving as a general reference for the Division staff, the Enforcement Manual also provides the general public with information regarding the Division's operations, keeping consistent with the CFTC's intent to increase transparency, certainty and consistency in enforcement principles.

The Enforcement Manual covers a broad array of topics, including:

- an overview of the CFTC and CEA and the underlying regulations;
- an overview of the Division;
- how the Division deals with enforcement "leads;"
- opening and conduct of preliminary inquiries and investigations;
- commencement and conduct of litigation by the Division;
- consideration of self-reporting, cooperation and remediation in enforcement decisions;
- enforcement cooperation with other regulators;
- assertion and protection of privileges and confidentiality; and
- the CFTC's whistleblower program.

The Enforcement Manual is available here.

UK DEVELOPMENTS

FCA Updates National Private Placement Regime Notification Process Under AIFMD

On May 2, the UK Financial Conduct Authority (FCA) updated its webpage on the United Kingdom's national private placement regime (NPPR) under the Alternative Investment Fund Managers Directive (AIFMD).

The NPPR allows non-European Economic Area (EEA) alternative investment funds (AIFs) that are managed by full-scope UK and EEA alternative investment fund managers (AIFMs), as well as any AIFs managed by non-EEA AIFMs, to be marketed in the United Kingdom.

The FCA's updated webpage explains that, going forward, AIFMs will need to use the FCA's Connect system to submit marketing notifications and notifications of material changes in the following circumstances:

1. marketing AIFs managed by small third-country AIFMs (i.e., marketing under Regulation 58 of the Alternative Investment Fund Managers Regulations 2013 (the AIFM Regulations);
2. marketing, without a passport, AIFs managed by non-EU AIFMs (i.e., marketing under Regulation 59 of the AIFM Regulations); and
3. marketing AIFs managed by UK AIFMs (i.e., marketing under Regulation 57 of the AIFM Regulations).

Previously all such notifications were required to be emailed to the FCA; this change now requires all such notifications to be made online only.

The FCA's updated webpage is available here.

EU DEVELOPMENTS

ESMA Publishes Final Reports on Technical Advice on Integrating Sustainability Risks and Factors in the UCITS Directive, AIFMD and MiFID II

On May 3, the European Securities and Markets Association (ESMA) published final reports on technical advice to the European Commission (EC) on integrating sustainability risks and factors in the core EU asset management directives:

1. the Undertakings for the Collective Investment in Transferable Securities (UCITS) Directive;
2. the Alternative Investment Fund Managers Directive (AIFMD); and
3. the revised Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR).

ESMA's reports include a number of general comments arising from the initial consultation it conducted in December 2018 on its technical proposals and its response.

ESMA also explained in a related press release that its initial consultation contained a separate paper on guidelines for disclosure requirements applicable to credit ratings, including the consideration of environmental, social and governance (ESG) factors. It expects to publish the final report of this paper by the end of July.

While it remains to be seen whether the EC will transpose all of ESMA's recommendations into amendments to the UCITS Directive, AIFMD, MiFID II and MiFIR, it seems highly likely that the outcome of ESMA's reports is that EU asset managers will be required to take into account sustainability risks and ESG factors as a mandatory element of selecting investments for their clients.

ESMA will now liaise with the EC in order to transform its technical advice into formal delegated legislation.

ESMA's final report relating to the UCITS Directive and AIFMD is available here.

ESMA's final report relating to MiFID II and MiFIR is available here.

ESMA's press release is available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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