

MEMO# 31769

May 20, 2019

SEC Proposes Rule and Form Amendments Revising Financial Disclosures for Fund Mergers; Conference Call Scheduled for May 30

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May 20, 2019 TO: Accounting/Treasurers Committee RE: SEC Proposes Rule and Form Amendments Revising Financial Disclosures for Fund Mergers; Conference Call Scheduled for May 30

The SEC has proposed rule and form amendments designed to tailor the financial reporting requirements for investment company acquisitions of other investment companies.^[1] Where a fund acquires private fund, the proposal reduces the number of financial statement fiscal periods that must be provided for the acquired fund. The proposal would also eliminate the pro forma financial statement requirement for investment company acquisitions of other investment companies.

We have scheduled a member call to discuss the proposal for **Thursday, May 30 at 2:00 pm Eastern**. Please contact Magen Dargon at magen.dargon@ici.org by Wednesday May 29 to receive dial-in information for the call. If you have any comments on the proposal, please contact Greg Smith at smith@ici.org. Comments on the proposal are due 60 days after publication in the Federal Register.

The proposal would add a definition of “significant subsidiary” in Regulation S-X specifically tailored for investment companies in lieu of the existing definition at Rule 1-02(w) of Regulation S-X. The new definition would be based on the definition of significant subsidiary in Investment Company Act Rule 8b-2 with some modifications. Certain investment companies may use the definition in Rule 1-02(w) when applying Regulation S-X Rule 3-05 to determine the financial statement periods to be presented for acquired funds.

The proposal would add new Rule 6-11 to Regulation S-X. The proposed rule would cover financial reporting in the event of a fund acquisition and would apply to the acquisition of another investment company, including a registered investment company, a business development company, a private fund, and any private account managed by an investment adviser. New Rule 6-11 utilizes the proposed definition of significant subsidiary to determine whether financial statements for the acquired fund must be provided.

The proposal would eliminate the current pro forma financial statement requirement for investment company acquisitions and replace it with proposed Rule 6-11(d), which would require investment companies to provide a table showing current fees for the acquiring fund, the acquired fund, pro forma fees after giving effect to the acquisition and certain narrative information.

We briefly summarize the proposal below.

Background

There are no specific rules or requirements in Article 6 of Regulation S-X for investment companies relating to the financial statements of acquired funds. When a registered investment company acquires a registered investment company, the acquiring fund must present financial statements for the acquired fund for the most recent fiscal year and any interim period as required by Form N-14 and Rule 3-18 of Regulation S-X.^[2] In addition, the acquiring fund must provide pro forma financial statements as required by Article 11.^[3]

Where a registered investment company acquires a private fund, the SEC staff may analogize to the general requirements of Regulation S-X (*i.e.*, Rule 3-05) to determine the financial statement fiscal periods to be presented for the acquired fund. It is often unclear how to apply Rule 3-05 to investment company acquisitions because it was written for operating companies. As a result, funds frequently consult with Commission staff in such acquisitions.^[4]

When a registrant acquires a business, Rule 3-05 requires the registrant to provide audited annual and unaudited interim pre-acquisition financial statements for the acquired business if it is significant to the registrant. Whether an acquisition is significant under Rule 3-05 is determined by applying the i) investment, ii) asset, and iii) income tests contained in Rule 1-02(w).

The investment test considers investments in and advances to the acquired business as compared to the total assets of the registrant in its most recent annual financial statements filed prior to the acquisition. The asset test considers the registrant's proportionate share of the acquired business's total assets reflected in the business's most recent annual pre-acquisition financial statements compared to the total assets of the registrant in its most recent annual financial statements filed prior to the acquisition. The income test considers the registrant's equity in the income from continuing operations of the acquired business before income taxes as reflected in the business's annual pre-acquisition financial statements compared to the same measure of the registrant reflected in its most recent annual financial statements filed prior to the acquisition.

The registrant's reporting requirements for the acquired business are determined based on a sliding scale approach. If none of the Rule 1-02(w) tests exceeds 20 percent, then financial statements for the acquired business are not required. If any of the tests exceed 20 percent, but none exceed 40 percent, the registrant must provide financial statements for the acquired business for the most recent fiscal year and any interim periods. Additional fiscal years may be required if any of the tests exceed 40 percent or 50 percent. Registrants required to file Rule 3-05 financial statements for significant acquisitions are also required to file pro forma financial statements as prescribed by Article 11.

Definition of Significant Subsidiary

The proposal would add new Rule 1-02(w)(2) to create a separate definition of "significant subsidiary" for investment companies in Regulation S-X. The proposed definition is based

on current Rule 8b-2 with modifications.^[5] The proposed definition includes an investment test and an income test. A subsidiary would be considered a significant subsidiary if it meets either of the two tests.

Under the investment test, the subsidiary would be considered significant if the value of the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

The proposed income test considers the absolute value of the income, gains, and losses of the subsidiary in relation to the absolute value of the registrant's change in net assets from operations. Specifically, the subsidiary is significant if the absolute value of the combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary, for the most recently completed fiscal year exceeds:

- A. 80 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; or
- B. 10 percent of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated for the most recently completed fiscal year and the Investment Test condition exceeds 5 percent ("Alternate Income Test").

However, if the registrant and its subsidiaries consolidated has an insignificant change in net assets resulting from operations for its most recently completed fiscal year, the test may be calculated using the average of the absolute value of such amounts for the registrant for each of its last five years.

As described below, proposed Rule 6-11 would use the proposed definition of significant subsidiary to determine whether an acquiring fund must present financial statements for an acquired or to be acquired registered investment company, business development company or private fund. The proposed definition may also affect investment company disclosures required by Regulation S-X Rule 3-09 regarding separate financial statements for significant subsidiaries and Regulation S-X Rule 4-08(g) regarding summarized financial information for subsidiaries not consolidated. These disclosure requirements typically affect business development companies.^[6]

Proposed Rule 6-11

Proposed Rule 6-11 would cover financial reporting in the event of a fund acquisition. The proposed rule would apply to an investment company acquisition of a registered investment company, a business development company, a private fund, and any private account managed by an investment adviser.

Registered investment companies acquiring other registered investment companies would continue to provide financial statements for the acquired fund for the periods specified in Rule 3-18 as they do today.

If the acquired fund is a private fund, then the acquiring fund would apply the definition of significant subsidiary to determine whether financial statements for the acquired fund must be provided. In particular, the conditions specified in the definition of significant subsidiary under proposed Rule 1-02(w)(2) would be applied, using the investment test and the

Alternate Income Test and substituting 20 percent for 10 percent. If either test is satisfied, then the registrant must provide financial statements for the acquired fund for the most recent fiscal year and the most recent interim period. In addition, the registrant must provide the supplemental financial information described below.

If the acquired fund is a private fund, the proposal would require the registrant to provide financial statements prepared in accordance with GAAP and also the schedules required by Article 12 of Regulation S-X. Accordingly, the financial statements for the private fund could not present a condensed schedule of investments.^[7] The proposal notes that when a registrant acquires a private fund, it typically must revise the financial statements of the acquired fund so that they comply with Regulation S-X. The proposal is intended to achieve a balance by permitting registrants to file GAAP financial statements for acquired private funds that may not comply with all elements of Regulation S-X.

The proposed rule also addresses the acquisition of a group of related funds none of which individually is significant. If the aggregate impact of individually insignificant funds acquired exceeds the conditions of the investment test and the Alternate Income Test, substituting 50 percent for 10 percent, then the registrant would be required to provide financial statements for each individually insignificant fund for the most recent fiscal year and any interim period, and the supplemental financial information described below.

Supplemental Financial Information In lieu of Pro Forma Financial Statements

The proposal would eliminate the current pro forma financial reporting requirement for investment companies required by Article 11 of Regulation S-X. In lieu of the pro forma financial information the registrant would be required to provide:

- i. A table showing the current fees for the registrant and the acquired fund and pro forma fees, if different, after giving effect to the acquisition using the format prescribed in the appropriate registration statement form;
- ii. If the transaction will result in material changes to the acquired fund's portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to reflect the change and narrative disclosure describing the change; and
- iii. Narrative disclosure about material differences in financial and operating policies of the acquired fund when compared to the registrant.

Form N-14

The proposal makes conforming changes to *Item 14 – Financial Statements* of Form N-14. Those changes specify that if the investment company to be acquired is a private fund, the registrant must provide the acquired fund's financial statements for only the most recent fiscal year and the most recent interim period.

Gregory M. Smith
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endnotes

^[1] *Amendments to Financial Statement Disclosures about Acquired and Disposed*

Businesses, Release Nos. 33-10635, 34-85765, IC-33465 (May 3, 2019) *available at* <https://www.sec.gov/rules/proposed/2019/33-10635.pdf>.

[2] These acquired fund financial statements are typically incorporated by reference into the Form N-14 filed by the acquiring fund.

[3] Pro forma financial statements need not be provided if the net asset value of the company being acquired does not exceed 10 percent of the acquiring fund's net asset value. See Item 14 of Form N-14.

[4] We understand the SEC staff typically requires financial statements of the acquired fund for the two most recent years in these acquisitions.

[5] The proposal would also amend Rule 8b-2 to make it consistent with the proposed definition of significant subsidiary in Rule 1-02(w)(2).

[6] See Business Development Companies-Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries; IM Guidance Update No. 2013-07 (September 2013) *available at* <https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-07.pdf>.

[7] FASB ASC 946-210-50-6.