

MEMO# 32501

June 1, 2020

SEC Adopts Rule and Form Amendments Revising Financial Disclosures for Fund Acquisitions

[32501]

June 1, 2020 TO: ICI Members SUBJECTS: Disclosure
Fund Accounting & Financial Reporting RE: SEC Adopts Rule and Form Amendments
Revising Financial Disclosures for Fund Acquisitions

The Securities and Exchange Commission recently adopted rule and form amendments designed to tailor the financial reporting requirements for investment company acquisitions of other investment companies.^[1] The rule and form amendments i) add a definition of “significant subsidiary” in Rule 1-02(w) of Regulation S-X tailored for investment companies based on the current Investment Company Act Rule 8b-2 definition of significant subsidiary with some modifications; ii) add new Rule 6-11 to Regulation S-X to address financial reporting requirements for acquisitions of investment companies, including a private fund, private account, or business development company; and iii) eliminate the pro forma financial information requirement in Form N-14 and replace it with supplemental financial information intended to be more relevant to fund investors.

Amendments to Significance Tests

Currently investment companies are required to use the significant subsidiary tests in Rule 1-02(w) when applying Rule 3-05^[2] and other rules within Regulation S-X.^[3] Those tests, however, were developed for operating companies and are difficult to apply to investment companies. The SEC has amended Rule 1-02(w) to create a separate definition of “significant subsidiary” tailored to investment companies. Specifically, new Rule 1-02(w)(2) includes an investment test and an income test to determine significance for investment companies.

Under the investment test, a 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 income test considers the absolute value of the income, and the gains and losses of the subsidiary in relation to the absolute value of the registrant’s change in net assets from operations to test significance. Specifically, the subsidiary is significant if the absolute value

of the sum 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").

In a change from the original proposal, if the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated is at least 10 percent lower than the average of the absolute value of such amounts for each of the last five fiscal years, then the registrant may compute both conditions of the income test using the average of the absolute value of such amounts for the registrant and its subsidiaries consolidated for each of its last five fiscal years.[\[4\]](#)

Rule 6-11

Currently there are no specific rules in Article 6 for investment companies that address financial statements of acquired funds. Instead, funds apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11, although it is often unclear how to apply these requirements in the context of acquired funds. Investment companies typically file Rule 3-05 financial statements in transactions in which an investment company with limited assets and operating history is created for the purpose of acquiring a private fund operating under the exclusions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

Investment company registrants will follow new Rule 6-11, rather than Rule 3-05, in the event that a fund acquisition occurs or is probable to occur. Rule 6-11 applies to the acquisition of a fund, including any investment company as defined in Section 3(a) of the Investment Company Act, any private fund that would be an investment company but for the exclusions in Sections 3(c)(1) or 3(c)(7), or any private account managed by an investment adviser.

Rule 6-11 uses the significant subsidiary definition in Rule 1-02(w)(2) as the basis for determining whether financial statements for the acquired fund must be filed. Specifically, financial statements of the fund acquired or to be acquired must be filed if the investment test is satisfied substituting 20 percent for 10 percent, or the alternate income test is satisfied substituting 20 percent for 10 percent. The significance tests in Rule 6-11 only apply to situations covered in paragraph (b)(2) and not paragraph (b)(1). Accordingly, an investment company registrant filing a registration statement on Form N-14 in connection with the acquisition of another fund will not apply the significance test in Rule 6-11(b)(2). Form N-14, however, permits the acquired fund's financial statements to be incorporated by reference into the filing.[\[5\]](#)

As proposed, Rule 6-11 would have required an investment company registrant to include acquired fund financial statements as part of the registrant's financial statements until its next audited balance sheet after the acquisition was consummated. In response to

comments the final rule requires the acquired fund's financial statements to be filed only once.

The final rule makes clear that if the acquired fund is subject to Rule 3-18, then the financial statements for the periods described in Rule 3-18 must be filed. For all other acquired funds, such as private funds, only the financial statements for the most recent fiscal year and any interim period must be filed.

The acquired private fund's financial statements must be audited and comply with US GAAP, except that the private fund must also comply with Article 12 of Regulation S-X. The adopting release explains that this approach is intended to achieve an appropriate balance by permitting registrants to file audited US GAAP financial statements for acquired private funds but supplementing those financial statements with audited schedules listing each investment as required by Article 12.

Pro Forma Financial Information

The amendments eliminate the requirement to provide pro forma financial information for investment company registrants and substitute supplemental financial information intended to better inform fund investors about the combined company. Currently Rule 11-01 of Regulation S-X requires pro forma financial statements unless the net asset value of the company being acquired is 10 percent or less of the acquiring fund's net asset value. As adopted Rule 6-11(d) makes clear that registered investment companies should provide specified supplemental financial information in lieu of pro forma financial information. The supplemental financial information consists of:

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

Transition

Registrants will not be required to apply the final amendments until the beginning of the registrant's fiscal year beginning after December 31, 2020. Acquisitions that are probable or consummated after December 31, 2020 must be evaluated for significance using final amendments. Voluntary early compliance is permitted provided that the final amendments are applied in their entirety.

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endnotes

[1] *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, Release Nos. 33-10786, 34-88914, IC-33872 (May 20, 2020) (“Adopting Release”) available at <https://www.sec.gov/rules/final/2020/33-10786.pdf>.

[2] Rule 3-05 specifies the financial statements to be filed for businesses acquired or to be acquired. Whether financial statements for the acquired business are required to be presented, and if so the periods to be presented, are based on the significance tests in Rule 1-02(w). Going forward investment companies will apply new Rule 6-11 to determine the financial statements to be filed for funds acquired or to be acquired.

[3] For example, Rule 3-09 regarding separate financial statements for significant subsidiaries and Rule 4-08(g) regarding summarized financial information of subsidiaries not consolidated.

[4] As proposed, the adopted rule amendments conform the definition of “significant subsidiary” in Investment Company Act Rule 8b-2(k) to the definition in Rule 1-02(w)(2).

[5] Item 14 of Form N-14 requires financial statements of the acquiring fund and the acquired fund. Those financial statements, however, may be incorporated by reference. See Instruction G.