EVERSHEDS SUTHERLAND

Legal Alert: SEC proposes revised "significant subsidiary" tests for investment companies and reduced financial information requirements for fund acquisitions

May 15, 2019

On May 3, 2019, the Securities and Exchange Commission (SEC) voted to propose rule amendments with regard to financial disclosures about acquired and disposed businesses (the "Proposal"), including amendments specific to business development companies and registered closed-end funds (collectively, "Investment Companies"). Among other things, the Proposal includes a new definition of "significant subsidiary" in Rule 1-02(w) that is tailored for Investment Companies. The SEC also proposed a new Rule 6-11 for Regulation S-X and amendments to Form N-14, both of which would impact financial reporting of Investment Company acquisitions. The proposed changes will also impact the financial disclosure requirements for acquired businesses in Rules 3-05 and 3-14 of Regulation S-X.

The proposed amendments will be subject to a 60-day public comment period following its publication in the Federal Register. The full text of the Proposal is available at https://www.sec.gov/rules/proposed/2019/33-10635.pdf.

Proposed revisions to "Significant Subsidiary" tests

Various rules under Regulation S-X, including Rules 3-05, 3-09 and 4-08(g), currently require Investment Companies to apply the definition of "significant subsidiary" in Rule 1-02(w). For example, Investment Companies are required to use the "significant subsidiary" test in Rule 1-02(w) when assessing whether separate financial statements or summarized financial information of certain significant portfolio companies need to be included in such Investment Company's periodic reports pursuant to Rules 3-09 and 4-08(g) of Regulation S-X. The Proposal offers a new Rule 1-02(w)(2), which would revise two of the three Rule 1-02(w) current significance tests (the investment test and the income test) and eliminate the asset test for Investment Companies. The SEC believes that the proposed "significant subsidiary" definition under new Rule 1-02(w)(2) would allow Investment Companies to "avoid unnecessary regulatory complexity and the potential confusion associated with the existing definitions."

Revisions to investment test

Currently, the investment test under Rule 1-02(w) measures whether the registrant's and its other subsidiaries' investment in and advances to the tested subsidiary exceeds 10% of the registrant's *total assets* on a consolidated basis. Under the proposed Rule 1-02(w)(2), the investment test would instead measure whether an Investment Company's investment in and advances to the tested subsidiary exceeds 10% of the *value of the total investments* of the Investment Company on a consolidated basis. Thus, the denominator for the investment test would be the value of total investments, instead of total assets, as of the end of the most recently completed fiscal year determined in accordance with US GAAP and Section 2(a)(41) of the Investment Company Act of 1940, as amended (the "1940 Act").

Contacts

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed or the Eversheds Sutherland attorney with whom you regularly work.

Steven B. Boehm
Partner
stevenboehm@eversheds-sutherland.com
+1.202.383.0176

Vlad M. Bulkin
Partner
vladbulkin@eversheds-sutherland.com
+1.202.383.0815

Terri G. Jordan
Counsel
terrijordan@eversheds-sutherland.com
+1.202.383.0976

Ingrid E. Messbauer
Associate
ingridmessbauer@eversheds-sutherland.com
+1.202.383.0826

Related People/Contributors

- Steven B. Boehm
- Cynthia R. Beyea
- Vlad M. Bulkin
- Stephani M. Hildebrandt
- Cynthia M. Krus
- Stephen E. Roth
- Payam Siadatpour
- R. Christian Walker
- Terri G. Jordan
- Ingrid E. Messbauer

Elimination of asset test
As requested by Sutherland in its November 30, 2015 comment letter, the asset test currently included in Rule 1-02(w), which compares the proportionate share of the total assets of the tested subsidiary to the total assets of the registrant on a consolidated basis, would not be included in the proposed Rule 1-02(w)(2) because the SEC finds that the asset test is generally not meaningful when applied to Investment Companies.

Revisions to income test
Currently, the income test under Rule 1-02(w) measures whether the registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes of the tested subsidiary, exclusive of amounts attributable to any non-controlling interests, exceeds 10% of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. Under the proposed Rule 1-02(w)(2), the income test would adopt the income test from Rule 8b-2 of the 1940 Act, which measures the total investment income of the tested subsidiary against the investment income of the registrant and its consolidated subsidiaries. However, the proposed income test under Rule 1-02(w)(2) would include any net realized gains and losses and net change in unrealized gains and losses in calculating both the investment income for the tested subsidiary and the registrant's total investment income, and would utilize an 80% threshold, rather than the 10% threshold in Rule 8b-2. Moreover, under Rule 1-02(w)(2), a tested subsidiary would be deemed significant if the test yields a condition of greater than either (1) 80% by itself, or (2) 10% *and* the investment test yields a result of greater than 5% (which the SEC refers to as the "alternate income test"). A proposed instruction to Rule 1-02(w)(2) would permit registrants to compute the income test using the average of the registrant's total investment income for the past five years.

The SEC's discussion of, and request for comment on, the proposed Rule 1-02(w)(2) is set forth on pages 97-106 of the Proposal. Please see Annex A for a list of the specific questions relating to the proposed Rule 1-02(w)(2) for which the SEC is seeking comment.

Reduced financial information requirements for fund acquisitions
In addition to the revised "significant subsidiary" tests, revisions to Rule 3-05 would, among other things, no longer require separate financial statements of an acquired business once the business has been included in the registrant's post-acquisition financial statements for a complete fiscal year, clarify when financial statements and pro forma financial information are required, and require the financial statements of the acquired business to cover only the two most recent fiscal years. The proposed amendments would also bring Rule 3-14 in line with the revised Rule 3-05.

The SEC also proposed a new Rule 6-11 for Regulation S-X, which would cover financial reporting in the event of a fund acquisition of another Investment Company, a private fund, or any private account managed by an investment adviser, and would be based on the revised Rules 3-05 and 3-14. Rule 6-11 will

look at the facts and circumstances to evaluate whether a fund acquisition has occurred, which will include the acquisition of all or substantially all portfolio investments held by another fund.

Among other things, under Rule 6-11: (i) only one year of audited financial statements would be required for fund acquisitions, which is a change from existing Rule 3-05 requirements that require between one and three years of audited financial statements; (ii) Investment Companies would be permitted to provide financial statements for acquired private funds that were prepared in accordance with GAAP without revising and re-auditing them to comply with Regulation S-X requirements, but such financial statements will need to be supplemented with schedules listing each acquired fund's portfolio investment as required by Article 12 of Regulation S-X, and (iii) the proposed Rule 1-02(w)(2) would be applied in determining whether financial statements of acquired funds must be provided, using the investment test and the alternate income test for Investment Companies and substituting 20% for 10%.

The SEC is also proposing to eliminate the requirement to provide pro forma financial information for Investment Companies in connection with fund acquisitions, which is currently required by Rule 11-01 of Regulation S-X. In place of the current requirement, the SEC is proposing new Rule 6-11(d) to require Investment Companies to provide supplemental information about the newly combined entity including, among other things: (i) a pro forma fee table that shows the fee structure of the combined entity; (ii) if the acquisition will result in a material change to the acquired fund's investment portfolio, a schedule of investments (supplemented with narrative disclosure) of the acquired fund modified to show the effects of such change, and (iii) narrative disclosure about material differences in accounting policies of the acquired fund in comparison to the combined entity.

The Proposal also contemplates revising financial statement disclosure requirements of Form N-14, which is the form used by Investment Companies to register securities issued in business acquisition transactions, to be consistent with the financial reporting requirements of the proposed Rule 6-11.

The SEC's discussion of, and request for comment on, the proposed Rule 6-11 is set forth on pages 111-117 of the Proposal. Please see Annex B for a list of the specific questions relating to the proposed Rule 6-11 and changes to Form N-14 for which the SEC is seeking comment.

Annex A

SEC requests for comment on proposed Rule 1-02(w)(2)

- Should we create a separate definition of significant subsidiary in Rule 1-02(w) of Regulation S-X specifically for investment companies? If so, is the proposed definition appropriate when used for Rules 3-09 and 4-08(g) and

proposed Rule 6-11 with respect to investment companies?

- Should we make corresponding changes to the definition of significant subsidiary in Rule 8b-2? Are there reasons, with respect to investment companies, that the definitions of significant subsidiary in Rule 8b-2 and Regulation S-X should differ?

- Should we utilize the value of total investments of an investment company as a denominator rather than total assets for the proposed investment test for investment companies? Should we change the numerator to a different metric than value of investments in and advances to the tested subsidiary? If so, which metric and why? Should we use the definition of value from the Investment Company Act for purposes of the Regulation S-X definition of significant subsidiary?

- Should an asset test apply to investment companies? Are there situations in which an asset test would uniquely identify a significant subsidiary? If we were to retain an asset test for investment companies, how could it be modified to better reflect measures of significance relevant to investment companies?

- Should we establish an income test for investment companies to utilize the absolute value of the sum of: (1) investment income, such as interest, dividend, and other income; (2) change in unrealized gain/loss, and (3) realized gain/loss as the numerator? If so, should we also change the denominator to be the investment company's absolute value of change in assets resulting from operations? Should we use absolute values of these entries from the statement of operations or should we use the absolute value of the gain or loss on each individual portfolio security? Are there other measures we should consider?

- Should we increase the threshold of the income test for investment companies to 80%? Should we make the proposed income test for investment companies conjunctive with the proposed investment test for investment companies? Are the proposed thresholds of 10% and 5% appropriate or should they be different? If different, what thresholds should we use to make the proposed income test conjunctive with the proposed investment test?

- Should we base the proposed income test for investment companies on the individual absolute value of the components rather than netting them out? For example, in a fund with significant investment income, that income could be offset by an equal amount of realized and unrealized losses, creating a relatively small change in net assets resulting from operations. If we were to use the absolute value of each of the components, should we reduce the threshold of the proposed income test?

- Under our proposal, a five-year average would be used for the income test

for investment companies if the registrant and its subsidiaries consolidated has an insignificant change in net assets resulting from operations for the most recent fiscal year. Should the five-year average also be required for the tested subsidiary under similar circumstances? Should this proposed amendment be more similar to the one for non-investment company registrants? Should a five-year average be required only if the absolute value of the change in net assets resulting from operations for the most recent fiscal year is at least 10% lower than the average of the absolute value of such amounts for the registrant for each of its last five years?

- We are proposing amendments to Rule 1-02(w)(2) to assist investment company registrants in making significance determinations. Are the proposed amendments appropriate? If not, are there different or additional amendments we should consider?

- Should we make further modifications to the proposed income test for investment companies in situations where the tested subsidiary is not an investment company? For example, should we require the use of net income for a non-investment company subsidiary when compared to the registrant's change in net assets resulting from operations?

- Instead of having specific percentage conditions, should we adopt a materiality standard? For example, should we adopt a standard that deems a subsidiary as significant if it is material to an understanding of the registrant's financial condition?

Annex B

SEC Requests for Comment on Proposed Rule 6-11 and Changes to Form N-14

- Should we adopt proposed Rule 6-11 for acquisitions of funds by registrants? Have we appropriately defined what constitutes a fund acquisition? Are there other types of private funds not covered by the Section 3(c)(1) or 3(c)(7) exclusion that should be covered? Is it appropriate to use a facts and circumstances-based evaluation to determine whether a fund acquisition has or will occur? Are there other factors that should be considered in defining a fund acquisition?

- Should we permit the presentation of audited financial statements of acquired funds for only the most recent fiscal year? Should we require the same reporting periods required by Rule 3-18 instead? If so, should we permit any registered investment company registrant, such as unit investment trusts, to use Rule 3-18 and not limit it to only registered management investment companies?

- Should we treat business development companies and registered investment companies the same? Should business development

companies follow the reporting periods set forth in proposed Rule 3-05 instead of proposed Rule 6-11?

- Should we require registrants to provide the audited schedules required by Article 12 for an acquired private fund, including a schedule of investments that requires each investment to be listed separately? Should we require only a smaller set of schedules required by Article 12, such as those required by Rules 12-12, 12-12A, 12-12B, 12-12C, and 12-13? Should we allow registrants to provide schedules that are permitted under US GAAP rather than Article 12?

- Is there any other disclosure by a registrant or an acquired fund that would be important to a fund investor? If so, please specify in detail.

- Should we permit registrants to have the option to file financial statements on an individual or a combined basis for acquired funds that are part of a group of related funds for any periods they are under common control or management?

- Should we continue to use the significant subsidiary definition as the basis for evaluating whether financial statements of an acquired fund should be filed? If so, is 20% the appropriate threshold? If not, what would be the appropriate threshold?

- Should we not apply the 80% income test for purposes of determining whether financial statements of an acquired fund should be filed?

- Should we permit a registrant to cease providing audited financial statements of the acquired fund once an audited balance sheet for the registrant is filed that reflects the assets of the acquired fund? Should the registrant be required to continue to file audited financial statements of the acquired fund until an audited statement of operations for a complete fiscal year reflecting the acquired fund has been filed?

- Is it appropriate to permit the financial statements of an acquired private fund to comply with US GAAP and only the schedule requirements in Article 12? Should we require Article 12 schedules to be filed with respect to the acquired private fund, even though it may be likely to result in additional costs?

- Is the proposed language related to independence standards sufficiently clear? Should we specify the "applicable independence standards?" If so, how should they be specified? Are there circumstances where there are no "applicable independence standards?" In those circumstances, which independence standards should apply?

- Should we eliminate the requirement for investment companies to provide pro forma financial statements for the combined entity after a business

acquisition? To what extent does pro forma financial information remain material in the investment company context? Please provide specific examples of how the current pro forma financial information is utilized.

- Should we require the pro forma fee table, schedule of investments and narrative disclosure as outlined above? Is there other information we should require in lieu of pro forma financial statements of the combined entity? If so, what other information would be material to investors?

- Should we conform the financial statement disclosure requirements in Item 14 of Form N-14 with proposed Rule 6-11? If not, how and why should the disclosures differ?

- Should we require the supplemental financial information to be disclosed in Form N-14?

If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Eversheds Sutherland attorney with whom you regularly work.