Proskauer

SEC Issues Final Rules on Registered Investment Company and Business Development Company Acquisition and Financial Statement Disclosure

July 10, 2020

The Securities and Exchange Commission (the "SEC") recently adopted final rules[1] (the "Final Rules") amending Regulation S-X and related rules and forms in a manner that directly impacts registered investment companies and business development companies ("BDCs", and together with registered investment companies, "investment companies") by substantially rewriting the rules that require reporting companies to file certain pre-acquisition financial statements, as well as certain financial statements of certain unconsolidated subsidiaries of BDCs. The Final Rules largely adopted the proposed rules and take effect on January 1, 2021. Voluntary early compliance is permitted if the amendments are applied in their entirety from the date of early compliance.

In addition to these revisions, the Final Rules also amended Rules 3-05 and 3-14 of Regulation S-X. For further information on the amendments to Rule 3-05, which applies to acquired businesses that are not real estate operations, and Rule 3-14, which applies to real estate operations, please see our alerts available here and here.

Acquisitions Specific to Investment Companies

Investment companies are required to comply with Rule 3-05 of Regulation S-X ("Rule 3-05") for significant acquisitions of other investment companies and private funds.[2] However, certain aspects of Rule 3-05 and the current significance test under Rule 1-02(w) of Regulations S-X ("Rule 1-02(w)") are either inapplicable to investment companies or inconsistent with other financial reporting rules applicable to investment companies. Following effectiveness of the Final Rules, new Rule 6-11 of Regulation S-X ("Rule 6-11") and amendments to Rule 1-02(w) will be more tailored to the attributes of, and the financial reporting scheme otherwise applicable to, investment companies.

Scope. As adopted, Rule 6-11 applies when an investment company acquires a fund. Rule 6-11 defines a "fund" as:

- any investment company as defined in Section 3(a) of the Investment Company Act of 1940, as amended (the "1940 Act"), including a BDC;
- any company that would be an investment company but for the exclusions provided by Sections 3(c)(1) and 3(c)(7) of the 1940 Act; or
- any private account managed by an investment adviser.

Rule 6-11 also implements a facts-and-circumstances test to determine whether an investment company has "acquired" a fund.[3] While application of a facts and circumstances test is consistent with Rule 3-05, new Rule 6-11 further identifies the following circumstances that would be considered a fund acquisition:

- the acquisition of all or substantially all of the portfolio investments of the fund; and
- an acquisition of a fund's portfolio investments that would comprise all or substantially all of the initial assets of the registrant.[4]

Significance. Upon effectiveness of the Final Rules, Rule 1-02(w)(2) will provide a separate definition of "significant subsidiary" and related significance tests that are specific to investment companies. The new significance tests will conform Rule 1-02(w) and Rule 8b-2 under the 1940 Act by eliminating the asset test and making certain modifications to the investment and income tests that are applicable to operating companies. Investment companies will now be subject to the following two significance tests:

- an "investment test," under which a subsidiary will be considered significant if the value of the investments in the subject subsidiary exceeds 10% of the value of total investments of the registrant and its consolidated subsidiaries as of the end of the most recently completed fiscal year; and
- an "income test" under which a subsidiary will be considered significant if the absolute value of the sum of (a) combined investment income from dividends, interest, and other income, (b) the net realized gains and losses on investments and (c) for purposes of the net change in unrealized gains and losses on investments from the tested subsidiary (except, for purposes of Rule 6-11, the absolute value of the change in net assets resulting from operations of the tested subsidiary), for the most recently completed fiscal year exceeds:

- 80% of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries on a consolidated basis for the most recently completed fiscal year; or
- 10% of the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries on a consolidated basis for the most recently completed fiscal year and the investment test described above is at least 5%.
- However, if the absolute value of the change in net assets resulting from operations of the registrant and its subsidiaries consolidated is at least 10% lower than the average of the absolute value of such amounts for each of its last five fiscal years, then the registrant may compute both conditions[5] 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. This represents a departure from the proposed rules, addressing a commenter's concern that a particularly volatile subsidiary could have an outsized impact that might affect the registrant's ability to satisfy the income test.

Periods Required. Currently, Rule 3-05 requires investment companies to provide between one and three years of audited financial statements in connection with a fund acquisition. As adopted, Rule 6-11[6] will require only a single year of audited financial statements for a fund acquisition that is significant. The new rule aligns with the financial reporting obligations under Rule 3-18 of Regulation S-X, which allows registered investment companies to file only one year of audited financial statements in their registration statements.[7] In addition, Rule 6-11 will require interim and supplemental financial information only at certain significance levels, and will apply the significant subsidiary tests in Rule 1-02(w)(2), with certain modifications, to measure significance. The Final Rules require investment companies to file separate financial statements for acquired funds as follows:

- if neither of the significance tests set forth under Rule 1-02(w)(2) is satisfied at the 20% level, financial statements and supplemental information are not required;
- if either significance test is satisfied at the 20% level, financial statements for the most recent fiscal year and the most recent interim period must be filed, as well as certain supplemental financial information described below; and
- if the aggregate impact to an investment company of acquired funds and probable acquisitions causes either significance test to be satisfied at the 50% level, financial statements for the most recent fiscal year and the most recent interim period must

be filed for each such fund, as well as certain supplemental financial information described below.

As proposed, Rule 6-11 would have required an investment company to include acquired fund financial statements as part of its financial statements until its next audited balance sheet after the acquisition was consummated. However, given the availability of the acquired fund financial statements on the SEC’s EDGAR system once filed and that the price of investment company shares or interests is established by the value of its current investment portfolio, the Final Rules permit acquired fund financial statements not to be included in future filings. [8] Furthermore, the Final Rules make clear that the separate financial statements of the acquired fund and the supplemental information described below need to be filed only once and not included in any subsequent filing or shareholder report.

Content of Financial Statements and Supplemental Disclosure. Upon effectiveness of the Final Rules, Rule 6-11 will require financial statements of acquired funds to be prepared in accordance with Regulation S-X, including the schedules required by Article 12. The requirement to include Article 12 schedules, which are not required under either Rule 3-05 or Rule 3-14, reflects the SEC's belief that the most relevant financial information in the context of a fund acquisition is the schedule of investments that shows the portfolio assets being acquired.

If the fund to be acquired would be an investment company but for the exclusions provided by Sections 3(c)(1) and 3(c)(7) of the 1940 Act, then the financial statements provided need only comply with U.S. GAAP and Article 12 of Regulation S-X.[9] That is, a schedule of investments that complies with Article 12 would need to be produced, but otherwise U.S. GAAP-compliant financial statements would not need to be reissued to comply with the remainder of Regulation S-X. This could save significant time and expense associated with re-issuing and re-auditing historical financial statements for acquired private funds, including affiliated funds contributing assets in connection with formation transactions undertaken by closed-end funds and BDCs.

Rather than providing pro forma information, which is required for acquisitions of businesses or real estate operations, Rule 6-11 will require investment companies to provide certain supplemental financial disclosures, including:

- a pro forma fees and expenses table for the combined entity post-acquisition;[10]

- if any material changes in the portfolio holdings of the acquired fund will result from the acquisition due to investment restrictions, a pro forma schedule of investments of the acquired fund reflecting such changes, along with a narrative description of the changes; and
- a description of any material differences in the accounting policies of the acquired fund and the combined entity post-acquisition.

BDCs and Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries.

BDCs currently are required to provide separate financial statements under Rule 3-09 or summarized financial information under Rule 4-08(g) for unconsolidated significant subsidiaries, including controlled portfolio companies. Under the historic significance tests in Rule 1-02(w), BDCs were required, absent SEC staff relief, to undertake the expense of providing financial statements for controlled portfolio companies that represent a small portion of the investment portfolio but, due to realized and unrealized gains or losses, represent a significant portion of the BDC's income for a period.

Under the Final Rules, the denominator used in the investment test applicable to BDCs will be total investments, rather than total assets, which will result in the significance test being satisfied at a lower investment level.

The amended income test, on the other hand, avoids requiring investment companies to undertake the expense of providing financial statements for subsidiaries that represent less than 5% of the investment portfolio but represent a significant portion of the BDC's income for a period. This is expected to require BDCs to provide either separate audited financial statements or summarized financial information for fewer of their controlled portfolio companies under Rules 3-09 and 4-08(g).

---

[1] SEC Release No. 33-10786; 34-88914 (May 21, 2020), available at https://www.sec.gov/rules/final/2020/33-10786.pdf.

[2] Investment companies must prepare their financial statements in accordance with Articles 1 through 4 of Regulation S-X, unless a special rule is set forth in Article 6. See Rule 6-03 of Regulation S-X.

[3] Many of the attributes of a "business" as that term is used in Rule 3-05, such as revenue-producing activity, physical facilities and production techniques, are not applicable to investment companies.

[4] This scenario would apply in connection with many of the formation transactions undertaken by closed-end funds and BDCs immediately prior to their elections to be regulated as such.

[5] The Final Rules clarified that the five-year averaging applies to both prongs of the income test (80% of the absolute value alone, and 10% of the absolute value and 5% under the investment test) in such situations.

[6] The SEC made clear in the Final Rules that Rule 6-11, and not Rule 3-05, would be the rule for investment companies to follow.

[7] While BDCs generally are required to provide two years of audited balance sheets and schedules of investments and three years for audited statements of operations, cash flows and changes in net assets, Rule 6-11 (and the related amendment to Form N-14) now require only a single year of financial statements be provided by BDCs.

[8] For example, if an investment company produces an audited schedule of investments following one or more contribution transactions, further financial statements for the corresponding acquired fund would no longer be required.

[9] In recognition of the traditional manner in which funds prepared their financial statements, the SEC allowed, but did not require, BDCs to provide financial statements for private funds that were prepared in accordance with U.S. GAAP, as opposed to the more extensive requirements found in Article 12 of Regulation S-X (requiring a full schedule of investments).

[10] A table of pro forma fees is currently required by Form N-14.

Related Professionals

- **Frank Zarb**
  Partner