New York
Northern California
Washington DC
São Paulo
London
Paris
Madrid
Tokyo
Beijing
Hong Kong

Davis Polk

Davis Polk & Wardwell LLP
450 Lexington Avenue
New York, NY 10017
212 450 4000 tel
212 701 5800 fax

July 29, 2019

Re: Request for Comment on Financial Disclosures About Acquired and Disposed Businesses
Release No. 33-10635; 34-85765; IC-33465
File No. S7-05-19

via e-mail: rule-comments@sec.gov

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Ms. Countryman:

We are submitting this letter in response to the above-referenced request by the Securities and Exchange Commission (the "**Commission**") for comment. We support the Commission's willingness to review the financial disclosure requirements relating to acquired and disposed businesses and appreciate the proposed modifications, some of which we and others had suggested to the Commission in response to its 2015 *Request for Comment on the Effectiveness of Financial Disclosure About Entities Other than the Registrant* (the "**Concept Release**").

In general, we believe that the proposal is an important and significant step towards easing the reporting burden of public companies and would help to achieve the goal of improving information available for investors while at the same time reducing the costs and complexity of preparing disclosure, thereby facilitating more timely access to capital.

As we noted in our response to the Concept Release, the current tests used for determining disclosure required by Rule 3-05 of Regulation S-X are designed to require financial information about material acquisitions, but they often lead to anomalous or "false positive" results. For example, when a buyer has a large market capitalization, but grew organically so that it has a lower GAAP asset value, even small acquisitions can be captured based on a purchase price test. Similarly, when a buyer is quite large from a revenue or asset perspective but has low pre-tax income due to substantial interest expense, even small acquisitions of debt-free businesses can be captured. We believe that the proposed rules will significantly reduce the occurrence of

false positive results. While we set forth some specific revisions below, we are in overall strong support of the amendments in the proposing release. We appreciate the opportunity to comment.

1. Modification to the "Investment Test"

The proposed change to the "investment test" used to determine the significance of an acquisition or disposition, which would require a comparison of the company's investment in the acquired business to the "aggregate worldwide market value" of the company's voting and non-voting equity, is a welcome change to the previous test. It will avoid many of the "false positive" examples we set out above.

However, we are concerned that the current proposal to test market capitalization as of the end of the company's most recently completed fiscal year may still lead to false positives. For example, a buyer could enter into a transaction in November after a significant run-up in its value, and its market capitalization at the prior year-end would be much lower than current realities. Instead, we would recommend that the Commission require companies to measure worldwide market value at a date within 60 days prior to entry into the purchase agreement for the acquisition. We believe this change would lead to a comparison that is more meaningful to investors because it would show the significance of the company's investment in the target at the time of the purchase commitment.

In addition, we note that the investment test measures the company's investment in the acquired business to include assumed liabilities, and therefore the value of the acquired business is not just the value of its equity but also debt. We further suggest that the revised investment test allow the addition of the principal amount of the acquirer's outstanding debt to its equity market value so that the test more accurately compares enterprise value of the target to enterprise value of the acquirer.

We believe these further changes to the investment test would more accurately represent the significance of an acquisition or disposition.

Finally, we are concerned that the modification to the investment test will not help companies that have done an acquisition prior to an initial public offering, and these companies will continue to face false positives. Because IPO companies do not have a market cap prior to the time of the initial public offering, we would suggest that IPO companies be permitted to use either of the two following methods to measure significance in the investment test. First, an IPO company should be allowed to use a valuation established by an independent third party either: (i) in the context of an issuance of equity compensation, such as a report pursuant to Section 409A of the Internal Revenue Code or (ii) pursuant to a recent equity investment made in the pre-IPO company by an unaffiliated third party. Second, IPO companies should be allowed to use the low end of the stated price range included in the preliminary prospectus used for the roadshow and the number of shares expected to be outstanding immediately after pricing of the IPO (as set forth in such preliminary prospectus) to determine the buyer's market capitalization. Just as the Commission, in its Compliance and Disclosure Interpretations - *Fixing America's Surface Transportation (FAST) Act* (last updated Aug. 17, 2017), allowed emerging growth companies (EGCs) to omit financial statements of an acquired business if the EGC reasonably believes those financial statements will not be required at the time of an offering, we believe that, prior to filing of the preliminary prospectus with a price range, IPO companies should be permitted to omit financial

statements (including pro forma financial statements) that they reasonably expect to not be required at the time of marketing.

2. The Asset Test

Under the current proposal, the asset test would remain substantially the same other than certain clarifying changes. We believe that the Commission should eliminate the asset test, as we think that the asset test has limited utility to the investor in assessing the future impact of the acquisition on the registrant. Like the income test, the asset test can lead to false positives, which reduces its usefulness to investors. However, if the Commission decides to retain the asset test, we would suggest that the asset test be revised to include a market capitalization concept similar to that used in the investment test. Without a market capitalization test, the asset test as currently written can lead to many false positives, just as it does with the investment test. For example, many technology companies that were built organically do not have sizable GAAP assets, and so an acquisition can trigger a finding of significance even when the target is small compared to the company's market capitalization. If the Commission revises the rules to include a market capitalization concept, we would likewise suggest that it includes the elements suggested above in respect of the investment test.

3. Pro Forma Financial Information

We support the Commission's proposal to replace the existing pro forma adjustment criteria with those that are more clearly defined, which we believe will result in more consistent disclosure. We also believe that the Commission's proposal to allow presentation of reasonably estimable synergies and other transaction effects that have occurred or are reasonably estimated to occur in the pro forma adjustments will allow investors a better estimation of the future impact of the transaction.

We have a number of suggestions to improve the Commission's proposal:

Currently, Article 11 provides that the income statement would exclude non-recurring items directly related to the transaction, such as transaction costs. We understand the Commission's proposal to require the inclusion of all non-recurring charges in the income statement, with disclosure in a footnote identifying them. Given the Commission's attempt to make the pro forma financial information more meaningful as a portrait of future performance, we think this change is inconsistent with the Commission's overall intent, as the result would be to show an income statement burdened by one-time items that would not impact future results. We recommend that the Commission maintain the existing rules and instead provide clarity about how to define non-recurring items and address the particular concerns noted in the rule proposal. For instance, we believe that the transaction effects outlined in the proposal relating to Management's Adjustments (namely, the closing of facilities, discontinuing product lines, terminating employees and executing new or modifying existing agreements) should be clearly defined as "non-recurring" in the revised rules.

The Commission has suggested the inclusion of management synergies and cost savings estimates in a new column called "Management's Adjustments." While we think this is a good suggestion, we think further clarity is needed. For example, if a company expects to achieve synergies over time, should the synergies that are included be the first-year synergies or the full run rate synergies? Similarly, if the company expects to expend funds to achieve those cost

savings, should those be included? What if they are non-recurring? We believe that the final rules should clarify that Management's Adjustments include the full run rate synergies excluding costs that are non-recurring, as this disclosure would afford investors the most accurate picture of the effects of the acquisition. Should the Commission adopt such rules, we would additionally suggest that the rules require comprehensive disclosure in the footnotes of the related non-recurring costs and anticipated timing of the run-rate synergies.

While we also support including criteria such as reasonably estimable synergies and other effects of the transaction that have occurred or are reasonably likely to occur in the newly proposed Management's Adjustments column, we are concerned about the potential liability with respect to these adjustments for companies and, in the case of securities offerings, underwriters. To the extent that the Management's Adjustments contain forward-looking information, we suggest that the Commission provide a safe harbor for such information similar to that found in the Private Securities Litigation Reform Act's safe harbor rule (15 U.S.C. § 78u-5(c)). We believe that this safe harbor should include all presentations of pro forma information required in the final rule, including those in initial public offerings and exchange offers. As required under the PSLRA safe harbor, we suggest requiring "meaningful cautionary statements" to accompany such pro forma information. We also recognize that, pursuant to the U.S. Supreme Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), a company may be able to mitigate its liability by stating that it is its "belief" that the synergies will occur.

* * *

We appreciate the opportunity to participate in the process, and would be pleased to discuss our comments or any questions that the Commission or its staff may have, which may be directed to Michael Kaplan, Nicholas A. Kronfeld, Richard D. Truesdell, Jr., Derek Dostal, Maurice Blanco, Shane Tintle and Elizabeth Weinstein of this firm at 212-450-4000.

Very truly yours,

Davis Polk + Wardwell LLP