July 29, 2019

Via email (rule-comments@sec.gov)

Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
Attention: Ms. Vanessa Countryman, Secretary

Re: Amendments to Financial Disclosures About Acquired and Disposed Businesses (File Number S7-05-19)

Dear Ms. Countryman,

The Securities Industry and Financial Markets Association ("SIFMA") is writing in response to changes proposed by the Securities and Exchange Commission (the "Commission") to the rules regarding financial disclosures about acquired and disposed businesses (the "Proposal").[1] We appreciate the opportunity to provide comments to the Commission on the Proposal.

In our comment letter to the Commission's 2015 request for comment on the financial disclosure requirements for certain entities other than a registrant,[2] we offered suggestions for changes to Regulation S-X, including those regarding financial disclosures about acquired and disposed businesses. Our suggestions focused on maintaining the quality of disclosure for investors while making the registration and reporting process less burdensome for registrants. The Proposal

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[1] *Amendments to Financial Disclosures About Acquired and Disposed Businesses*, 84 Fed. Reg. 24,600 (proposed May 28, 2019).

[2] *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant*, 80 Fed. Reg. 59,083 (proposed Oct. 1, 2015).

[*] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly one million employees, we advocate for legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. With offices in New York and Washington, D.C., SIFMA is the U.S. regional member of the Global Financial Markets Association.

reflects consideration of our and others' suggestions, and we laud the work that the Commission has done to propose changes that will make compliance with Regulation S-X easier for issuers while providing more useful information to investors. In this letter, we suggest some revisions and additions to the proposed changes to the financial disclosure requirements in Regulation S-X and elsewhere that we believe would preserve the quality and timeliness of the disclosure that investors will receive with respect to acquired and disposed businesses while making the registration and reporting process less burdensome for registrants.

1. Regulation S-X Rule 1-02(w)

We generally support the proposed changes to the significance tests included in the definition of "significant subsidiary" in Rule 1-02(w). We ask the Commission to consider the following suggested revisions to certain elements of the Proposal:

- *Investment Test.* We support the Proposal's replacement of the denominator of total assets with aggregate worldwide market value of the registrant's voting and non-voting common equity ("AWMV"), when available, as we agree it is a better proxy for the registrant's current fair value than total assets, but we suggest the following revisions:
  - The definition of AWMV should be revised to limit the impact of market fluctuations on the test and allow more recent calculations to be used. We suggest that AWMV equal the product of (1) total outstanding common shares on any date within 30 days of initial filing or confidential submission, and (2) the average price of the common stock over the 60-trading day period ending on the tenth trading day before such filing or confidential submission, calculated using the closing price of the shares on each trading day during that 60-trading day period.
  - The Commission should confirm that the Investment Test based on AWMV need only be run once, prior to the initial filing or confidential submission of a registration statement or proxy statement, as applicable, and need not be rerun prior to effectiveness or mailing.
  - When AWMV is not available, we suggest retaining total assets as the denominator of the Investment Test. Because we believe, as noted above, it is important that the registrant make this determination only once, it will generally occur very early in the registration process (e.g., before the initial filing or confidential submission of a registration statement). Therefore, alternatives that

would require an estimate of an expected IPO issuance price or offering size would be too speculative to rely on for purposes of the Investment Test.

  - We support the Proposal's inclusion of contingent consideration in the numerator of the Investment Test insofar as it is required to be included at fair value under GAAP. The Proposal, however, goes beyond GAAP by requiring inclusion generally of contingent consideration for acquisitions accounted for under the equity method. Under GAAP, certain types of contingent consideration for such acquisitions are recognized *only* when the contingency is resolved. Accordingly, we recommend that the Proposal not require inclusion of the contingent consideration for acquisitions accounted for under the equity method that is not required to be included at fair value under GAAP.
    - At a minimum, we suggest that the Commission consider excluding other milestone-based contingent consideration (such as earn-outs), in addition to the two other exclusions included in the Proposal (sales-based milestones and royalties).
    - In calculating the numerator of the Investment Test, we also suggest that the Commission allow the use of gross value of contingent consideration, in lieu of fair value, as a permitted alternative and practical expedient.

- *Income Test.* We support the changes to the Income Test in the Proposal. We believe the addition of the revenue prong, which generally does not reflect non-recurring or unusual items, will best address the issues that often arise under the existing Income Test (that immaterial acquisitions are deemed significant after comparing the <u>net</u> operating results of an acquiree to that of an acquirer, particularly when one company has a net loss). We also believe any concerns that a two-pronged test may not capture certain material acquisitions would be counterbalanced by the general materiality determinations that must be considered under the existing liability regime.
  - The revenue component of the revised Income Test does not apply if either entity does not have "recurring annual revenue," but the Proposal does not provide a definition of that term, which is not used in the accounting literature, or explain why the "recurring" modifier was proposed. We note that GAAP revenue already excludes revenue from discontinued operations, so the modifier "recurring" would not be necessary in that context. The Commission should justify the use of a subjective term like "recurring" and define it; otherwise, we suggest that the

revenue component of the Income Test not apply if either entity simply has "no annual revenue."

- *Asset Test.* We note that the Proposal retains and does not amend the existing Asset Test. As we noted in our 2015 comment letter, we continue to believe there are few, if any, cases where the Asset Test would demonstrate the materiality of an acquisition where the alternative two tests would not, and suggest again that the Commission eliminate it for this purpose. From a balance sheet perspective, when the Investment Test is based on AWMV, the Asset Test is unnecessary as the value of a registrant's proposed investment relative to its market value is a far superior measure than a comparison of assets. However, even in the absence of a public trading market (e.g., in the context of an initial public offering), the only situation in which an Asset Test would be met but an Investment Test would not would be when the book value of the assets of the acquiree is greater than the fair value of the consideration, but even in that situation consideration is still a better measure of the value of the target than the book value of its assets.[3]

We agree with the Commission's retention of bright-line numerical thresholds in the definition of significant subsidiary. However, with respect to their use in connection with determining whether financial information related to acquired or disposed businesses is required, the Commission should consider establishing the numerical thresholds as non-exclusive safe harbors for determinations of significance, at or below which separate financial statements and related pro forma financial information would be deemed immaterial and above which registrants would still be able to conclude that some or all of the financial information is not required because it would not provide material information. Providing a non-exclusive safe harbor of immateriality is consistent with other disclosure requirements and would facilitate capital raising while maintaining disclosure consistency.[4]

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[3] For transactions between related parties, where consideration may not reflect the value of the target, the Investment Test provides an alternative measure for entities under common control.

[4] See e.g., Rule 430A under the Securities Act of 1933 (requiring the filing of a post-effective amendment for material changes to issue price or offering size, but providing for a 20% floor at or below which a change in offering size or issue price is deemed immaterial).

2. Regulation S-X Rule 3-05 / Financial Statements for Significant Acquisitions

As we noted in our 2015 comment letter, we believe the burden of preparing audited historical financial statements of an acquiree frequently outweighs the benefit of those financial statements to investors, particularly in the case of (1) a private acquiree either without audited historical financial statements or, more likely, with audited statements that are based on GAAP for private companies or that have not been audited in accordance with GAAS, or (2) an acquisition of less than the entirety of another entity, where carve-out historical financial statements need to be prepared. Therefore, we also support the proposed changes to Regulation S-X Rule 3-05, including the reduction of the number of periods to be presented at each level of significance and the ability to provide more limited financial statements for certain "carve-out" businesses. We ask the Commission to consider the following additional changes related to separate financial statements that we believe will further ease unnecessary burdens on registrants:

- *Form S-4 / Form F-4.* The Proposal states that the proposed amendments would not apply to financial statements related to the acquisition of a business that is the subject of a proxy statement or a registration statement on Form S-4 or Form F-4, which are based on the requirements of the applicable form and not Rule 3-05 (or Rule 8-04).[5] However, we believe the analysis by a recipient of a proxy statement or registration statement on Form S-4 or F-4 of the financial statements of a target company does not materially differ from that of a registrant's other investors pursuant to registration statements and other disclosure documents where the Rule 3-05 thresholds and requirements apply directly. From the perspective of an acquirer's shareholders, we believe the relevance of a target company's financial statements in a proxy / registration statement is equivalent to the target company's significance relative to the acquirer.

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[5] Inclusion of financial statements of a business acquired by a target company that is a reporting company *would* be based on Rule 3-05. Inclusion of those financial statements by a target company that is not a reporting company is only required if the omission renders the target company's financial statements substantially incomplete or misleading.

We therefore suggest that the Commission harmonize the target company financial statement requirements in proxy statements and registration statements on Form S-4 and F-4 with the significance levels and other amendments in the Proposal.[6]

Under the proxy statement rules and Form S-4 and F-4, in most cases three years of target company financial statements are currently required when an acquirer issuer's shareholders are voting, but, as the Proposal acknowledges, the third year of financial statements is less relevant for evaluating an acquisition due to their age. At a minimum, we request that the Commission revise the target financial statement requirements in the proxy statement rules and in Form S-4 and F-4 to also require no more than two years in any case, consistent with the changes to Rule 3-05 in the Proposal. We note that this revision would be consistent with market practice that two years of financial statements is sufficient information in the context of a proxy statement or registration statement on Form S-4 or F-4 for emerging growth companies.

- *Probable Acquisitions.* Companies with effective Form S-3 or Form F-3 shelf registration statements on file with the Commission are permitted to offer securities under those registration statements without providing investors audited historical financial statements of a probable acquiree, or pro forma financial information reflecting the probable acquisition, regardless of significance, unless the acquisition would represent a "fundamental change" to the registrant. In our 2015 comment letter, we recommended that the Commission consider eliminating the requirement that this information be provided for probable acquisitions exceeding 50% significance if a registrant is eligible to register securities on Form S-3 or Form F-3 but does not have an effective S-3 or F-3 on file with the Commission. We still do not believe there is any reason investors need additional information from companies that are qualified to use, but do not have on file, registration statements on Form S-3 or F-3 than they do from companies with effective shelf registration statements on file, a distinction without a difference from a disclosure perspective, and therefore reiterate our prior recommendation.

[6] We believe these requirements should be harmonized for both target companies that are non-reporting companies and target companies that are reporting companies. Although the requirement to include additional years may not be burdensome for reporting companies, those years are immaterial.

3. Article 11 of Regulation S-X

We generally support the proposed revisions to the requirements to provide pro forma financial information contained in Article 11 of Regulation S-X. However, we are deeply concerned about the *requirement* in the Proposal to include quantitative management adjustments that include projections related to synergies and other transaction effects ("Management's Adjustments") in the pro forma financial information or, if those synergies are not reasonably estimable, qualitative disclosures instead. Our concern arises from the incremental liability risk and the potential burden on registrants.

Specifically, we are concerned that:

- the requirement to include forward-looking information as part of Management's Adjustments is contrary to the Commission's disclosure rules generally, which do not require inclusion of forward-looking information or projections (other than known material trend disclosure included in Management's Discussion and Analysis sections). In practice, in light of the materiality standard, this disclosure is included only when the trend is adverse.
- underwriters will be unable to obtain comfort on and adequately diligence Management's Adjustments, yet will have risk of liability for a misstatement claim for materially overstated synergies.
- potential mismatches will exist (1) between projections announced at the signing of a transaction and the pro forma financial information provided later on in the process, and (2) in the case of Form S-4 or F-4, between the pro forma financial information and the disclosure regarding the financial advisor opinion, in either case resulting in additional risk of liability.
- registrants may not be able to prepare Management's Adjustments for pro forma financial information to be included in financing documents at or close to the time of signing the acquisition agreement on a timely basis or without unreasonable effort.

The Proposal includes a confirmation of the availability of the Rule 175 and Rule 3b-6 safe harbors within revised Rule 11-02. At a minimum, the Commission should also confirm that the PSLRA safe harbor applies to pro forma financial information because it is not a "financial statement." However, we do not believe these confirmations offer adequate protection to issuers and underwriters with respect to inclusion of quantitative or qualitative synergy projections, even

if, as we suggest, they are permissive rather than prescriptive, particularly where the PSLRA protections are unavailable (such as in initial public offerings).

4. Form 8-K Amendments

We note that the Proposal does not include a revision to Instruction 4(i) of Form 8-K Item 2.01, which requires disclosure for an acquisition or disposition of *assets* meeting the 10% asset significance test. We suggest that the Commission also amend that threshold to align with the other proposed changes to the thresholds in the Proposal (i.e., at the 20% level).

We also suggest that the Commission provide for a 75-day grace period in Form 8-K for financial disclosure requirements for dispositions, similar to that provided for separate financial statements and pro forma financial information for acquisitions.

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If you have any questions regarding SIFMA's views or require additional information, please do not hesitate to contact the undersigned at [redacted] or our counsel on this matter, Leslie N. Silverman, Jeffrey D. Karpf or Andrea M. Basham of Cleary Gottlieb Steen & Hamilton, at [redacted]

Very truly yours,

Aseel M. Rabie
Managing Director and Associate General Counsel