

SEC Publishes First Request for Comment on Disclosure Effectiveness Initiative, Focused on Four Distinct Regulation S-X Requirements

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As has been widely mentioned by SEC Commissioners and Staff, the Staff has been undertaking a broad-based review of disclosure requirements, known as the Disclosure Effectiveness Initiative. The Staff's initial focus is on business and financial information required in current and periodic reports. On Friday, the SEC [published](#) its first request for public comment regarding the financial disclosure requirements in Regulation S-X for certain entities other than a registrant.

Four rules being considered. Regulation S-X contains disclosure requirements that dictate the form and content of financial statements to be included in filings with the Commission. The discrete subset of the Regulation S-X disclosure requirements being evaluated for possible amendment include:

- *Rule 3-05, Financial Statements of Businesses Acquired or to be Acquired* (requires issuers to provide pre-acquisition and pro forma financial statements if an acquisition is deemed significant through a series of investment, asset and income tests);
- *Rule 3-09, Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons* (requires issuers to provide financial statements of entities that they own 50% or less of, if those entities are significant, based on investment and income tests);
- *Rule 3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered* (permits issuers to provide more limited disclosure under certain conditions, such as when the subsidiary issuer and guarantor is “100% owned” by the parent company and the guarantees are “full and unconditional”); and
- *Rule 3-16, Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered* (requires issuers to provide separate financial statements for each affiliate whose securities constitute a substantial portion of the collateral for any class of securities, as if the affiliate were a separate issuer).

Reasons the SEC may be interested in making changes. For Rule 3-05, the SEC appears concerned that the information required is limited in being able to predict the financial situation of the combined entity after the acquisition, and does not allow judgment to be applied to all of the facts and circumstances. The significance tests can be difficult to apply in some cases. Also, pro forma information lacks comparative prior periods and is unaudited, and restrictions on pro forma adjustments prohibit a company from reflecting other significant changes, such as workforce reductions and facility closings. Investors also need to wait 75 days for the information unless there is an earlier registration statement filed.

Problems with Rule 3-09 financial statements include that they may be presented using different accounting standards, fiscal year-ends, and/or reporting currencies other than those used by the company. Since the financial statements are required only for significant entities, they often cannot be reconciled to amounts recognized in a company's financial statement for that entity. Reconciliation is also difficult because the financial information of multiple entities may be aggregated in summary financial statements.

The SEC questions, for purposes of Rule 3-10, whether the standards to provide alternative disclosure may be too stringent. For example, a subsidiary that is organized in a jurisdiction that requires directors to own a small number of shares must obtain relief from the Staff to meet the “100% owned” test and guarantees that only become enforceable after the passage of some time period after default do not satisfy the “full and unconditional” requirement.

General comments requested for each of the rules. In addition to a few specific questions related to the unique nature of each rule, the release asks for comments on the same fundamental aspects for all of them: (a) how investors currently use the disclosure; (b) changes to consider to make the information more useful to investors; (c) challenges companies face in preparing and providing the required disclosure; and (d) whether any of the disclosures are not useful to investors and should be eliminated or replaced. For Rule 3-10 and Rule 3-16, the SEC also questions whether the rule impacts how transactions are structured.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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