On May 21, 2020, the Securities and Exchange Commission (the SEC) adopted rule amendments that will impact the requirement of Investment Companies (as defined below) to disclose the financial statements of certain of its portfolio companies or of a fund that the Investment Company acquires (the Final Rules). The amendments in the Final Rules were initially proposed in May 2019 (the Proposed Rules) and, as described below, the SEC adopted the Final Rules with certain modifications to the Proposed Rules. The Final Rules include rule amendments specific to business development companies (BDCs) and closed-end investment companies registered under the 1940 Act (registered closed-end funds, together with BDCs, the Investment Companies) and rule amendments generally applicable to other registrants.

This Legal Alert will focus on two parts of the Final Rules that are specific to Investment Companies:

• First, the Final Rules adopted a new definition of “significant subsidiary” set forth in Rule 1-02(w)(2). Rules 3-09 and 4-08(g) require Investments Companies to file separate financial statements or summary financial information, respectively, in such Investment Company’s periodic reports for any portfolio company that is deemed to be a “significant subsidiary” by meeting the conditions set forth in Rule 1-02(w). The Final Rules amend the definition of “significant subsidiary” by revising the conditions therein in a manner that will more accurately capture those portfolio companies that are more likely to materially impact the financial condition of an Investment Company.

• Second, the Final Rules adopt new Rule 6-11, which will address financial reporting relating to a fund acquisition by an Investment Company of another Investment Company, a private fund or any private account managed by an investment adviser.

The Final Rules will be effective on January 1, 2021, but voluntary compliance is permitted in advance of the effective date. The full text of the Final Rules is available here.

Amendments to the “significant subsidiary” definition

As described above, Rules 3-09 and 4-08(g), when read together with Rule 1-02(w), describe the circumstances under which the financial statements, or summarized balance sheet and income statement information, respectively, of a portfolio company that is deemed to be a “significant subsidiary,” must be presented in the notes to the financial statements of an Investment Company. Currently, a portfolio company will meet the definition of “significant subsidiary” if any of the following conditions set forth in Rule 1-02(w) are satisfied: (i) the
investment test; (ii) the asset test; or (iii) the income test.

Based upon its current provisions, Rule 1-02(w) may cause an Investment Company to trigger the disclosure requirements of Rule 3-09 or Rule 4-08(g) notwithstanding the fact that such portfolio company may represent an immaterial amount of the Investment Company’s portfolio during such period. The inclusion of a portfolio company’s financial statements or summary financial information could have the effect of overstating the significance of the portfolio company on the Investment Company’s performance.

In addition, the definition of “significant subsidiary” in Rule 1-02(w) differs from the definition of “significant subsidiary” in Rule 8b-2 under the 1940 Act (applicable to registered closed-end funds filing registration statements and reports under the 1940 Act), which includes a different income test and investment test and does not include the asset test. These inconsistent definitions have created unnecessary regulatory complexity and potential confusion.

As described more fully below, the Final Rules adopted a new definition of “significant subsidiary” in Rule 1-02(w)(2) that is tailored to Investment Companies by: (i) modifying the investment test and income test, and (ii) eliminating the asset test currently in the definition of “significant subsidiary” in Rule 1-02(w). The Final Rules also make the definition of “significant subsidiary” in Rule 1-02(w) more consistent with the definition of “significant subsidiary” in Rule 8b-2 under the 1940 Act. Moreover, while the SEC did not amend Rule 3-09 or Rule 4-08(g), the changes to the definition of “significant subsidiary” under new Rule 1-02(w)(2) will impact the application of Rule 3-09 and Rule 4-08(g) by Investment Companies.

Revisions to the 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 as of the end of the most recently completed fiscal year.

The investment test under new Rule 1-02(w)(2) will 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 as of the end of the most recently completed fiscal year. Thus, the denominator for the investment test will 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 generally accepted accounting principles (US GAAP) and Section 2(a)(41) of the 1940 Act.

By shifting the focus from the total assets to the value of total investments of the Investment Company, the investment test will no longer capture other non-investment assets that may be held by the Investment Company that are less
relevant for purposes of determining whether a portfolio company is significant.

**Elimination of the asset test**

Currently, the asset test under Rule 1-02(w) measures whether the registrant’s and its other subsidiaries’ proportionate share of the total assets of the subsidiary exceeds 10% of the total assets of the registrant and its subsidiaries on a consolidated basis as of the end of the most recently completed fiscal year. However, a portfolio company triggering the asset test is not indicative of the significance of such portfolio company investment to the Investment Company. For example, a portfolio company with a smaller amount of assets may be more profitable and valuable than a portfolio company with a larger amount of assets.

The Final Rules eliminate the asset test for Investment Companies under new Rule 1-02(w)(2). The SEC acknowledged that the asset test is generally not meaningful and confusing when applied to Investment Companies, and eliminating it will simplify compliance for Investment Companies when determining whether a portfolio company is deemed to be a “significant subsidiary.” Eliminating the asset test for Investment Companies will further align the definition of “significant subsidiary” in new Rule 1-02(w)(2) with Rule 8b-2 of the 1940 Act, which does not include the asset test.

**Revisions to the 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 on a consolidated basis for the most recently completed fiscal year.

The income test in new Rule 1-02(w)(2) will adopt the income test in Rule 8b-2 of the 1940 Act that measures the total investment income of a portfolio company against the investment income of the Investment Company and its consolidated subsidiaries, with certain modifications. Under new Rule 1-02(w)(2), a subsidiary will be deemed a “significant subsidiary” if the absolute value of the sum of (a) the combined investment income from dividends, interest, and other income, (b) the net realized gains and losses on investments, and (c) the net change in unrealized gains and losses on investments from the tested portfolio company, for the most recently completed fiscal year exceeds either:

- 80% of the absolute value of the change in net assets resulting from operations of the Investment Company and its subsidiaries consolidated for the most recently completed fiscal year; or

- 10% of the absolute value of the change in net assets resulting from operations of the Investment Company and its subsidiaries consolidated for
However, if the absolute value of the change in net assets resulting from operations of the Investment Company 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 an Investment Company may compute both conditions of the income test using the average of the absolute value of such amounts for the investment Company and its subsidiaries consolidated for each of the past five fiscal years. This 10% bright-line threshold will mitigate the potential adverse effects of the income test for Investment Companies with insignificant changes in net assets resulting from operations for its most recently completed fiscal year.

By including net realized gains and losses and the net change in unrealized gains and losses along with investment income in the calculation, the income test in new Rule 1-02(w)(2) provides a more meaningful financial metric for determining whether a portfolio company is deemed to be a “significant subsidiary” of an Investment Company.

**Reduced financial information requirements for fund acquisitions**

Currently, there are no specific rules or requirements in Article 6 for Investment Companies relating to the financial statements of acquired funds. Instead, Investment Companies apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11. It is often unclear how these reporting requirements apply in the context of acquired funds. As a result, Investment Companies frequently consult with SEC staff on its application as part of the registration and filing process, which can be a time-consuming process. In addition, Rule 3-05 requires an Investment Company acquiring a private fund to re-issue or re-audit historical financial statements for the acquired private fund (including affiliated funds contributing assets in connection with formation transactions).

The new Rule 6-11 will address financial reporting relating to a fund acquisition by an Investment Company of another Investment Company, a private fund, or any private account managed by an investment adviser, and will be based on the amended Rule 3-05 but tailored to Investment Companies. Rule 6-11 will implement a facts and circumstances test to allow an Investment Company to evaluate whether an Investment Company has “acquired” a fund. While the application of this test is consistent with Rule 3-05, new Rule 6-11 will be tailored to a fund acquisition by further identifying the following circumstances to consider when determining if a fund acquisition has occurred: (i) the acquisition of all or substantially all portfolio investments held by another fund; and (ii) an acquisition of a fund’s portfolio investments that would comprise all or substantially all of the initial assets of the Investment Company (e.g., formation transactions undertaken prior to electing to be regulated as an Investment Company).
Rule 3-05 currently requires registrants, including Investment Companies, to file between one and three years of audited financial statements of the business acquired or to be acquired. The determination of the periods that must be presented is determined using the conditions in the definition of “significant subsidiary” in Rule 1-02(w) as specified in Rule 3-05.

Under new Rule 6-11(b)(2), to determine (a) whether financial statements of the fund acquired or to be acquired and (b) whether certain pro forma supplemental information (as described in detail below) are required, Investment Companies will apply the investment test and the alternate income test under new Rule 1-02(w)(2) as follows:

- If neither the investment test nor the alternative income test exceed 20%, no financial statements are required.

- If either the investment test or the alternate income test exceeds 20%, financial statements for the most recent fiscal year and the most recent interim period must be filed.

- If, on an aggregate basis, the funds acquired or to be acquired since the date of the most recent audited financial statements filed by the Investment Company satisfies the investment test or the alternate income test 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.

Once the portfolio investments of the acquired fund have been reflected in the acquiring Investment Company’s most recent audited financial statements, the historical financial statements of the acquired fund will no longer be required to be filed.

Under new Rule 6-11, Investment Companies will be permitted to provide financial statements for acquired private funds that were prepared in accordance with US GAAP and comply with Article 12, which would require a schedule of investments for the acquired fund, but such financial statements will not need to comply with all the other requirements of Regulation S-X. This will save significant time and expenses associated with Investment Companies revising and re-auditing the financial statements of an acquired private fund to comply with other Regulation S-X requirements.

**Supplemental financial information**

The Final Rules also 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. In place of the current requirement, if the fund acquisition meets either the investment test or the alternate income test under new Rule 6-11(b)(2) described above, Investment Companies must
provide the following supplemental information under Rule 6-11(d) about the newly combined fund:

1. a fee table showing (a) the current fees for the Investment Company and the acquired fund and (b) the pro forma fees, if different, for the combined fund;

2. if the acquisition will result in a material change to the acquired fund’s investment portfolio due to investment restrictions, a schedule of investments showing such change, as well as a narrative description of the changes; and

3. narrative disclosure about material differences in accounting policies of the acquired fund in comparison to the acquiring fund (rather than the combined fund as contemplated in the Proposed Rules).

Amendments to Form N-14

The Final Rules also amend the financial statement disclosure requirements of a registration statement on 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 new Rule 6-11.

Key Takeaways and Next Steps

The Final Rules provide more tailored conditions pursuant to which Investment Companies will determine whether a portfolio company is deemed a “significant subsidiary.” By applying conditions that more accurately measure the actual impact of a portfolio company on an Investment Company’s financial conditions, new Rule 1-02(w)(2) will help reduce the significant time and expenses that Investment Companies incur in preparing separate financial statements or summary financial information under Rules 3-09 and 4-08(g), respectively. The Final Rules will also provide a disclosure framework for fund acquisitions by Investment Companies, which will address the inconsistencies and uncertainties that Investment Companies currently face when applying Rule 3-05 when acquiring funds.

While the Final Rules become effective on January 1, 2021, Investment Companies may take advantage of the benefits and comply with the Final Rules earlier than such date as long as they comply with the Final Rules fully. In this regard, Investment Companies can begin preparing now by assessing whether any portfolio company that is currently deemed to be a “significant subsidiary” under the current definition of “significant subsidiary” in Rule 1-02(w) will be deemed a “significant subsidiary” under the new Rule 1-02(w)(2) and whether financial information required by Rules 3-09 or 4-08(g) is required in the Investment Company’s upcoming periodic report. In addition, Investment Companies in the process of acquiring another fund may choose to rely on the less onerous requirements under new Rule 6-11.
The SEC provided a public comment period on the Proposed Rules, including a list of specific questions, that ended on July 29, 2019. For a summary of the Proposed Rules and the requests for comments, please refer to Eversheds Sutherland’s previous legal alert.

The term “1940 Act” refers to the Investment Company Act of 1940, as amended.

Unless otherwise indicated, all rule references herein are to rules and articles under Regulation S-X.

With respect to the Proposed Rules, commenters requested that the SEC make substantive amendments to Rule 3-09 and Rule 4-08(g). In the Final Rules, the SEC stated that “such amendments would be beyond the scope of this rulemaking.”

The term “private fund” refers to any private fund that would be an investment company but for the exclusions provided by Sections 3(c)(1) or 3(c)(7) of the 1940 Act.

Private funds often prepare audited financial statements in accordance with US GAAP but such financial statements are neither prepared nor audited in accordance with Regulation S-X.

New Rule 6-11 will not apply if the Investment Company acquired a non-substantial portion of another fund’s portfolio investments that would constitute all of the initial assets of the Investment Company. In the Final Rules, the SEC removed language included in the Proposed Rule that would have suggested otherwise.

The Final Rules amended Rule 3-05 to require between one and two years of audited financial statements for registrants other than Investment Companies.

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.