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SEC Proposes Amendments to Financial Statement Requirements Applicable to Real Estate Acquisitions and Dispositions

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Speed Read

The Securities and Exchange Commission has proposed amendments to Rule 3-14 of Regulation S-X and related rules and forms that are intended to harmonize the financial statement disclosure requirements in connection with acquisitions of significant real estate operations provided in Rule 3-14 with the requirements for acquisitions of significant businesses provided in Rule 3-05 of Regulation S-X, including with respect to the application of significance thresholds, periods to be covered by required financial statements and the timing of filing required financial statements. In addition, the proposed amendments clarify existing guidance concerning the application of Rule 3-14, and would include a number of technical revisions to Rule 3-14. The proposal is subject to a 60-day public comment period that ends on July 29, 2019.

On May 3, 2019, the SEC proposed amendments to, among other things, the financial disclosure requirements in Rule 3-05 of Regulation S-X ("Rule 3-05") and Rule 3-14 of Regulation S-X ("Rule 3-14"). The proposed amendments are intended to improve the information that investors receive regarding the acquisition and disposition of businesses, including real estate operations, and to reduce the complexity and associated compliance costs for registrants. This alert focuses primarily on the proposed changes to Rule 3-14 and its related rules and forms that may be of particular interest to REITs and other public real estate companies. For a more detailed discussion on the proposed amendments to Rule 3-05, [please click here](#).

Rule 3-14 currently sets forth the financial statement requirements for the acquisition or probable acquisition of real estate that generates revenue solely through leasing. The financial statement disclosure requirements in Rule 3-14 and the related interpretations by the staff of the SEC's Division of Corporation Finance (the "Staff") can potentially have a significant impact on a REIT's ability to buy and sell real estate, raise capital at a time of its choosing and generally comply with the SEC's reporting requirements.

The SEC's proposed amendments can be grouped into the following two categories:

- changes to align the financial statement disclosure requirements of Rule 3-14 and Rule 3-05 when no unique industry considerations exist; and
- other changes to Rule 3-14 to clarify existing Staff guidance and to make certain technical revisions.

The SEC's principal proposed amendments include:

- increasing the significance threshold for individual acquisitions from 10% of total assets to 20% of common equity market capitalization;

- aligning the Rule 3-14 significance threshold for the aggregate impact of (i) acquisitions for which financial statements are not required due to insignificance or are significant but not yet required to be filed and (ii) individual probable acquisitions, to those in excess of the 50% level for registration statements and proxy statements;
- eliminating the requirement to provide three years of financial statements for a real estate operation acquired from a related party such that only one year of financial statements would be required;
- amending Rule 3-06 to apply to Rule 3-14 financial statements to permit the filing of financial statements covering a period of nine to 12 months to satisfy the requirement for filing financial statements for a period of one year for an acquired or to be acquired real estate operation;
- amending Rule 3-14 to align the significance and timing of filing requirements in registration statements and proxy statements with Rule 3-05;
- permitting the omission of Rule 3-14 financial statements in registration statements and proxy statements once the acquired real estate operation has been reflected in the registrant's filed post-acquisition financial statements for a complete fiscal year;
- clarifying that the audited financial statements will be subject to auditor independence standards; and
- amending Form 8-K to increase the significance threshold for dispositions of a "business" (including real estate operations) to 20% under all of the significance tests.

The proposed amendments are summarized in more detail below.

PROPOSED AMENDMENTS TO ALIGN RULE 3-14 WITH RULE 3-05

| Proposed Amendments | Current Rules and Staff Guidance |
|---|---|
| <i>Significance Thresholds For Individual Acquisitions</i> | |
| <ul style="list-style-type: none"> • An acquisition would be significant if the registrant's investment in the real estate operations exceeds 20% of the aggregate worldwide market value of the registrant's voting and non-voting common equity, or if the registrant has no worldwide market value, such as a non-traded REIT, the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year or in certain circumstances based on more recent pro forma financial statements. Aggregate worldwide market value of the registrant's voting and non-voting common equity will be determined as of the last business day of the registrant's most recently completed fiscal year, which for acquisitions and dispositions will be at or prior to the date of acquisition or disposition. When the investment test is based on total assets of the registrant, assumed debt secured by the property would be included in determining the amount of the investment.[1] | <ul style="list-style-type: none"> • An acquisition is significant if the registrant's investment is 10% or higher of the registrant's total assets at the latest audited fiscal year end filed with the SEC. The investment includes any debt secured by the property that is assumed by the purchaser. |
| <i>Measuring Significance for Individually Insignificant Acquisitions</i> | |
| <ul style="list-style-type: none"> • Would increase the Rule 3-14 significance threshold for the aggregate impact of (i) acquisitions for which financial statements are not | <ul style="list-style-type: none"> • Rule 3-14 financial statements are required in registration statements and proxy statements, as applicable, when individually insignificant |

| Proposed Amendments | Current Rules and Staff Guidance |
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| <p>required due to insignificance or are significant but not yet required to be filed and (ii) individual probable acquisitions, to those in excess of the 50% level for registration statements and proxy statements. This 50% significance level would be measured based on common equity market capitalization or total assets consistent with the tests noted above for individually significant acquisitions. If the acquisitions and probable acquisitions are in excess of the 50% level, a registrant would be required to provide pro forma financial statements reflecting the aggregate effects of all such aggregate acquisitions (not just a mathematical majority), but separate historical financial statements would only be required for acquisitions whose individual significance exceeds 20% for which financials are not yet otherwise required (i.e., probable acquisition or consummated acquisitions that are still in the 74-day grace period).</p> | <p>consummated and probable acquisitions since the date of the most recent audited balance sheet are 10% or more significant in the aggregate. In this case, Rule 3-14 financial statements must be provided for each acquisition that is 5% or more significant and total acquisitions representing more than 50% of the aggregate purchase price of all of such acquisitions.</p> |
| <i>Years of Required Financial Statements for Acquisitions From Related Parties</i> | |
| <ul style="list-style-type: none"> Would eliminate the Rule 3-14 requirement to provide three years of financial statements for acquisitions from related parties to conform to Rule 3-05, such that only one year of financial statements would be required for such acquisitions.[2] | <ul style="list-style-type: none"> One year of audited Rule 3-14 financial statements is required for most acquisitions, but three years of audited Rule 3-14 financial statements are required for acquisitions from related parties. |
| <i>Application of Rule 3-06</i> | |
| <ul style="list-style-type: none"> Rule 3-06 would apply to both Rule 3-14 and Rule 3-05 equally to permit the filing of financial statements covering a period of nine to 12 months to satisfy the requirement for filing financial statements for a period of one year for an acquired or to be acquired real estate operation. | <ul style="list-style-type: none"> Rule 3-06 applies only to Rule 3-05 financial statements, not Rule 3-14 financial statements. |
| <i>Less Than 50% Significant</i> | |
| <ul style="list-style-type: none"> Rule 3-14 financial statements of an acquired or to be acquired real estate operation would not need to be included in a registration statement or proxy statement if less than or equal to 50% significant, and either (i) the consummation of the acquisition has not yet occurred; or (ii) the date of the final prospectus or prospectus supplement relating to an offering as filed with the SEC, or mailing date in the case of a proxy statement, is no more than 74 days after consummation of the acquisition of the real estate operation, and the | <ul style="list-style-type: none"> This accommodation is currently included in Rule 3-05 but a corresponding provision is not included in Rule 3-14. |

| Proposed Amendments | Current Rules and Staff Guidance |
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| financial statements have not previously been filed by the registrant. | |
| Complete Fiscal Year | |
| <ul style="list-style-type: none"> No longer would require Rule 3-14 financial statements in registration statements and proxy statements once the acquired real estate operation has been reflected in filed post-acquisition registrant financial statements for a complete fiscal year. | <ul style="list-style-type: none"> A variation of this accommodation is currently included in Rule 3-05 but a corresponding provision is not included in Rule 3-14. |

OTHER PROPOSED AMENDMENTS TO RULE 3-14

| Proposed Amendments | Current Rules and Staff Guidance |
|---|---|
| Definition of Real Estate Operation | |
| <ul style="list-style-type: none"> Rule 3-14 would define a real estate operation as “a business that generates substantially all of its revenues through the leasing of real property,” which is consistent with the current practice (as described in the right-hand column) and is intended to address the fact that the acquisition of a real estate operation may be of an entity holding real property under lease or a direct interest in the real property. | <ul style="list-style-type: none"> Neither Regulation S-X nor any other Securities Act or Exchange Act rule provides a definition of a real estate operation or an explanation of what is meant by the reference to properties in Rule 3-14. The Staff has interpreted, for purposes of Rule 3-14, a real estate operation to refer to properties that generate revenues solely through leasing, but has not interpreted this definition to preclude a property that includes a limited amount of non-leasing revenues (like property management or other services related to the leasing) from being considered a real estate operation. The Staff has also provided guidance that a real estate operation includes real properties that will be held directly by the registrant or through an equity interest in a pre-existing legal entity that holds the real property under lease and related debt. |
| Interim Financial Statements | |
| <ul style="list-style-type: none"> Rule 3-14 would specifically require Rule 3-14 financial statements for the most recent year-to-date interim period prior to the acquisition. | <ul style="list-style-type: none"> Unlike Rule 3-05, Rule 3-14 does not include an express requirement for registrants to provide interim financial statements.[3] |
| Smaller Reporting Companies and Issuers Relying on Regulation A | |
| <ul style="list-style-type: none"> Rule 8-06 would direct registrants to proposed Rule 3-14 for the requirements relating to financial statement disclosures of real estate operations acquired or to be acquired, while still permitting smaller reporting companies to rely on the form and content for annual and interim financial statements provided in Rules 8-02 and 8-03. | <ul style="list-style-type: none"> Rule 8-06 provides smaller reporting company disclosure requirements for the financial statements of real estate operations acquired or to be acquired that are substantially similar to the requirements in Rule 3-14. Part F/S of Form 1-A directs an entity relying on Regulation A to present financial statements of real estate operations acquired or to be acquired as specified by Rule 8-06. |

| Proposed Amendments | Current Rules and Staff Guidance |
|---|---|
| <i>Blind Pool Real Estate Offerings</i> | |
| <ul style="list-style-type: none"> Would codify the Staff's interpretations related to blind pool real estate offerings by revising Rule 3-14 to provide that significance for blind pool offerings will be computed consistent with the Staff's current guidance (as described in the right-hand column). In addition, Rule 3-14 would permit the determination of significance for acquisitions of real estate operations in blind pool offerings to be made using pro forma total assets as of the end of the most recently completed fiscal year included in the Form 10-K.[4] | <ul style="list-style-type: none"> During the Industry Guide 5 distribution period, the Staff has interpreted the significance test for all property acquisitions, including properties that are triple net leased (see below), to be computed by comparing the registrant's investment in the property to the registrant's total assets as of the date of the acquisition plus the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months. After the distribution period has ended, the Staff has understood the registrant to be able to determine significance using the total assets as of the acquisition date until the registrant files its next Form 10-K. After that next Form 10-K is filed, the registrant, following the Staff's guidance, can determine significance using total assets as of the end of the most recently completed fiscal year included in the Form 10-K. |
| <i>Triple Net Leases</i> | |
| <ul style="list-style-type: none"> The SEC's proposal does not provide for different reporting requirements with respect to time-of-acquisition reporting for an acquisition of a real estate operation subject to a triple net lease with a single lessee or specify alternative requirements even when there is significant asset concentration. | <ul style="list-style-type: none"> Pursuant to current Staff guidance with respect to time-of-acquisition reporting, registrants provide full audited financial statements of the lessee or guarantor of the lease of real estate operations subject to a triple net lease with a single lessee, instead of the Rule 3-14 financial statements of the real estate operation, when the asset concentration is considered significant (i.e., exceeds 20% of the registrant's assets as of its most recent balance sheet). |

In addition to the proposed amendments noted in the tables above, the SEC has proposed additional, minor changes to Rule 3-14. Specifically, these proposed amendments are intended to clarify that:

- to be acquired real estate operations should be evaluated under Rule 3-14 only if they are probable of acquisition and, accordingly, the current practice of interpreting the phrase "proposes to acquire" when discussing "to be acquired" real estate operations to mean "probable of acquisition" will be codified;
- the acquisition of an interest in a real estate operation accounted for using the equity method or, in lieu of the equity method, the fair value option, should be considered the acquisition of a real estate operation;
- where a real estate operation to be acquired is the subject of a proxy statement or registration statement on Forms S-4 or F-4, the financial statement periods to be presented are those specified by Rules 3-01 and 3-02 of Regulation S-X and the applicable form (i.e., generally, only one year of audited results unless the registrant's stockholders are voting or the real estate operation is an existing public company);
- real estate operations should be treated as a single acquisition for significance testing if they are "related," meaning they are under common control or management, the acquisition of one real estate operation is conditional on the acquisition of each other real estate operation, or each acquisition is conditioned on a single common event;

- using a more recent pro forma amount is permitted for significance testing in certain circumstances consistent with the application in Rule 3-05; and
- Rule 3-14 financial statements should be prepared and audited in accordance with Regulation S-X and should be for the period that the real estate operation has been in existence, if that period is shorter than the period explicitly required for the financial statements.

The SEC has also proposed to revise certain related forms to include express references to Rule 3-14 when applicable, where such forms currently reference only Rule 3-05, and has proposed the following specific amendments to Form 8-K:

- revise Item 2.01 to clarify that registrants are required to disclose the acquisition or disposition of assets that constitute a significant real estate operation as defined in Rule 3-14;
- address the filing requirements in Item 9.01(a) consistently for all business acquisitions, including real estate operations; and
- revise Item 2.01 Instruction 4 to reference Rule 3-14 to make clear that, as with Rule 3-05, the aggregate impact of acquisitions of real estate operations is not required to be reported unless these acquisitions are related real estate operations and significant in the aggregate.

The proposed amendments to Form 8-K would also raise the significance threshold for the disposition of a “business” (including real estate operations) from 10% to 20% under *any* of the significance tests used to determine significance for an acquired business, not just the investment test as is the case for the acquisitions of significant real estate operations.

While the proposed amendments may change as a result of the comment process, we are available to advise REITs and other real estate companies to help them better understand the potential impact on financial reporting for future acquisitions and dispositions as well as the opportunities that these proposed amendments may present. Please contact your regular Goodwin attorney or any of the individuals listed below if we may be of assistance.

[1] As proposed, under the common equity market capitalization test, the acquisition of real estate that is encumbered by debt would be treated differently from the acquisition of unencumbered real estate that the acquirer may intend to mortgage shortly after acquisition. In both instances, the denominator would be the same but the investment in the encumbered real estate would be measured using the value paid net of the debt value while the investment in the unencumbered real estate would be measured at full value.

[2] This proposal by the SEC will not affect the requirements set forth in Rules 3-01 and 3-02 of Regulation S-X for acquisitions of a “predecessor,” as defined in Securities Act Rule 405 (e.g., in connection with an initial registration statement and the corresponding transactions involving the combination of multiple entities with related or common ownership).

[3] Article 11 of Regulation S-X, however, requires pro forma financial information to be filed when the registrant has acquired one or more real estate operations which in the aggregate are significant. Article 11 further provides that the pro forma condensed statement of comprehensive income shall be filed for the most recent fiscal year and the period from the most recent fiscal year to the most recent interim date for which a balance sheet is required. To meet this requirement, registrants must prepare and present substantially the same information for the most recent interim period, if applicable, that would be included in Rule 3-14 financial statements in most circumstances.

[4] The proposed amendments are silent as to REIT formation transactions. Under the Staff's current guidance for REIT formation transactions, the Staff recognizes that the literal application of Rule 3-14 could result in the registrant providing financial statements of properties that are clearly insignificant to investors. In identifying the financial statements required to be included in the initial registration statement, the Staff has allowed registrants to compute significance using a denominator equal to the total cost of the properties acquired immediately prior to filing an initial registration statement, properties to be acquired upon closing the initial public offering, and properties identified as probable future acquisitions. In computing significance of any future property acquisition until the time the registrant files its Form 10-K covering the year the initial public offering is consummated, the registrant can use the same base as was used in the initial registration statement. However, that base should be reduced for any property not acquired or no longer probable. That base should not be reduced for probable acquisitions for which audited financial statements were included in the registration statement and the acquisition remains probable.

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