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The SEC's New Disclosure Regime for Real Estate Acquisitions - A User's Guide for REITs

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The Securities and Exchange Commission (the "SEC") recently adopted amendments to Regulation S-X and related rules and forms that will streamline and reduce the financial statements required to be filed in connection with significant business acquisitions by all SEC registrants.[1] As part of these amendments, the SEC overhauled Rule 3-14 of Regulation S-X, which applies to acquisitions of real estate operations and is therefore of critical importance to real estate investment trusts ("REITs"). Overall, the amendments eliminate many of the current inconsistencies between Rule 3-05 and Rule 3-14 and should reduce the reporting burden for REITs in connection with acquisitions and dispositions. Among other major changes, the amendments increased the quantitative significance threshold for acquisitions of real estate operations from 10% to 20% and eliminated elements of the Rule 3-14 disclosure regime that required registrants to file financial statements for insignificant acquisitions under circumstances where there was no corresponding requirement under Rule 3-05.

Registrants will be required to comply with the amended rules at the beginning of their fiscal years beginning after December 31, 2020. Registrants must comply with the amended rules for acquisitions and dispositions that are probable or consummated after that date. Voluntary early compliance is permitted if the amendments are applied in their entirety from the date of early compliance. Given the advantages the amended rules have over the current requirements, we expect that many REITs will avail themselves of this option.

The purpose of this article is to provide an overview of the disclosure requirements applicable to significant property acquisitions by REITs while also highlighting some of the major changes effected by the amendments. For further information on the amendments to Rule 3-05, which applies to acquired businesses that are not real estate operations, and new Rule 6-11, which applies to investment companies and business development companies subject to the Investment Company Act of 1940, please see our alerts available here and here.

Why did the SEC amend the rules?

The amendments are intended to improve the financial information about acquired or disposed businesses available to investors, facilitate more timely access to capital, and reduce the complexity (and cost to prepare) of the required disclosure. As a whole, the amendments narrow the requirements to file financial statements for significant acquisitions, consistent with the SEC's objective of reducing the costs to prepare required disclosure, while also rationalizing the tests used to determine whether an acquisition is significant. With respect to Rule 3-14, the amendments also serve to more closely align the disclosure requirements for acquisitions of real estate operations with those applicable to acquisitions of other businesses, while preserving important differences where unique real estate industry considerations warrant differentiated disclosure.

Prior to the amendments, there were significant differences between the requirements for acquisitions of real estate operations and for other business. Disclosure practices related to acquisitions of real estate operations developed over time largely in response to a fairly large body of SEC staff interpretive guidance that addressed ambiguities in Rule 3-14.[2] The amendments codify much of this guidance with modifications to eliminate many of the historical differences between Rule 3-14 and Rule 3-05. As such, the amendments should provide additional certainty to REITs regarding the timing and content of disclosures required under Rule 3-14, even where the amendments do not substantively change current reporting and disclosure practices under the SEC staff's interpretive guidance.

What is a "real estate operation"?

The first step to determining what pre-acquisition financial statements are required is to determine whether or not the acquired property is a real estate operation. As amended, Rule 3-14 defines a real estate operation as a business that generates substantially all of its revenues through the leasing of real property, which is consistent with current practice and staff interpretations. Notably, the adopting release confirmed, but did not codify, existing staff guidance that properties that generate revenues from operations other than leasing — such as hotels, nursing homes, golf courses and auto dealerships — are not real estate operations for these purposes. These types of properties, which are commonly purchased by REITs and other real estate investors, will continue to be subject to the disclosure requirements of Rule 3-05 rather than Rule 3-14. Thus, depending on the nature of the business acquired, REITs will continue to apply Rule 3-14 in connection with some acquisitions and Rule 3-05 in connection with others.

The adopting release confirmed that the determination of whether a property is a real estate operation is not a bright-line test and continues to be a question of facts and circumstances that may require consultation with the SEC. A property that generates a limited amount of non-leasing revenues (like property management or other services related to leasing) or a property that is not leased and generating revenues upon acquisition may still be a real estate operation. The amended rules do not address acquisitions of properties with limited rental histories, although relief from certain financial statements requirements for such properties may be available from the SEC staff.

What are the pre-acquisition financial statements and pro forma financial

information requirements in a registration statement or proxy statement?

As a general rule, separate pre-acquisition financial statements for any significant acquisition during the registrant's most recent fiscal year and the current fiscal year to date must be included in a registration statement or proxy statement.[3] The number of years of financial statements required and when they are required to be included in a registration statement or proxy statement depends on how significant the acquisition is and the significance of the REIT's other recent and probable acquisitions. If financial statements for a significant acquisition are included in a registration statement or a proxy statement, pro forma financial information prepared in accordance with Article 11 of Regulation S-X must also be included.

The chart below summarizes the basic requirements under Rule 3-05 and Rule 3-14, as amended, for acquired business financial statements and pro forma financial information.

Significance Level	Rule 3-05	Rule 3-14
Significance of an individual acquisition does not exceed 20%	No financial statements or pro forma financial information required	Same as Rule 3-05
Significance of an individual acquisition (or group of related acquisitions) exceeds 20% but does not exceed 40%	Financial statements for the most recent fiscal year (audited) and any interim period (unaudited), *without* the corresponding prior year interim period Pro forma financial information for the most recent fiscal year and the most recent interim period Must be filed within 74 days after consummation of the acquisition	Same as Rule 3-05
Significance of an individual acquisition (or group of related acquisitions) exceeds 40%	Financial statements for the two most recent fiscal years (audited) and any interim period (unaudited), *with* the corresponding prior year interim period (unaudited) Pro forma financial information for the most recent fiscal year and the most recent interim period Must be filed within 74 days after consummation of the acquisition	Financial statements for the most recent fiscal year (audited) and any interim period (unaudited), *without* the corresponding prior year interim period (*i.e.*, an additional year of financial statements is not required if significance of an acquired real estate operation exceeds 40%) Pro forma financial information for the most recent fiscal year and the most recent interim period Must be filed within 74 days after

Significance Level	Rule 3-05	Rule 3-14
		consummation of the acquisition
Significance of aggregate of all completed and probable acquisitions exceeds 50%	Financial statements for the most recent fiscal year (audited) and most recent interim period (unaudited) for all individual acquisitions (or groups of related acquisitions) above 20% significance Pro forma financial information for the most recent fiscal year and the most recent interim period that depicts the aggregate impact of all completed and probable acquisitions (significant or insignificant) in all material respects Must be filed with the registration statement (*i.e.*, 74-day grace period does not apply)	Same as Rule 3-05 If acquisitions of both real estate operations and other businesses are being tested, Rule 3-05 will apply and the real estate operations will be included as part of the calculation under the investment test only

How do the amendments change the pre-acquisition financial statement filing requirements for REITs?

For REITs, one of the most significant impacts of the amendments was to increase the threshold significance level under Rule 3-14 from 10% to 20%, bringing it equal to the threshold significance level under Rule 3-05. In contrast to Rule 3-05, however, Rule 3-14 continues to require only one year of audited financial statements for a significant acquisition, regardless of the significance level. Moreover, the 74-day grace period for filing financial statements after closing an acquisition, which previously was available only under Rule 3-05 or in connection with a Form 8-K, is now available under
Rule 3-14 in connection with a registration statement or proxy statement.

The amendments also eliminated a requirement for REITs to file financial statements of individually insignificant acquisitions when they are significant in the aggregate. Prior to the amendments, if the aggregate of completed and probable acquisitions of individually insignificant real estate operations exceeded 10% significance, SEC staff guidance directed the REIT to file financial statements for each acquisition exceeding 5% significance *and* financial statements for additional individually insignificant acquisitions until financial statements for more than 50% of the aggregate acquisitions had been filed. Following the amendments, pre-acquisition financial statements of individually insignificant real estate operations are not required under any circumstances. When the aggregate impact of all acquisitions (completed and probable) exceeds 50% significance, pre-acquisition financial statements must be filed for any individual acquisition that exceeds 20% significance, consistent with Rule 3-05.[4]

The amendments added a new requirement to both Rule 3-05 and Rule 3-14 mandating that, when the aggregate of all acquisitions (completed and probable) exceeds 50% significance, pro forma financial information depicting the aggregate impact of all such acquisitions in all material respects must be filed. Prior to the amendments, pro forma financial information was only required when pre-acquisition financial statements were also required. Accordingly, if auditor negative assurance on pro forma financial information is required in connection with an offering, the auditors may need to perform additional review procedures on the financial statements of a larger number of insignificant acquisitions. As a practical matter, this may result in continuation of the historical practice for REITs of including a provision in their purchase and sale agreements requiring the seller to provide to the REIT all information necessary to prepare financial statements required by SEC rules, even if the motivation for including the provision will now be driven more by the pro forma financial information requirement rather than the audited financial statements requirement.

How is "significance" tested?

To determine whether an acquisition is significant, both Rule 3-05 and Rule 3?14, as amended, refer to the definition of "significant subsidiary" under Rule 1-02(w) of Regulation S?X. Rule 1-02(w) provides three tests for significance: the investment test, the asset test and the income test. A registrant must apply all three tests to determine significance of a business acquisition under Rule 3-05. Under Rule 3-14, only the investment test applies to acquisitions of real estate operations.

- Investment Test. As amended, the investment test generally[5] is based on a registrant's investments in and advances to the acquired business or real estate operation as compared to either (i) the aggregate worldwide market value of the registrant's voting and non-voting common equity, or (ii) for registrants with no aggregate worldwide market value only (*e.g.*, non-traded REITs or pre-IPO REITs), the value of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year. Worldwide market value of the registrant's voting and non-voting common equity, a component of the test that was added as part of the amendments, is the average for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition.

  A registrant's "investments in" the acquired business or real estate operation is the consideration transferred, including contingent consideration. For acquisitions of real estate operations when the test is based on total assets only, any assumed debt secured by the real estate operation is considered an "investment in" the real estate operation for these purposes. Under other circumstances, any debt obligations assumed or new debt obligations incurred to finance the acquisition are not considered an "investment in" the acquired business or real estate operation and thus do not impact the significance test.

- Asset Test. The asset test was not changed by the amendments and requires a comparison of the registrant's share of the consolidated total assets of the acquired business to the consolidated total assets of the registrant.
- Income Test. As amended, the income is based on two different calculations that must both exceed the applicable threshold: (i) the absolute value of the registrant's equity in the pre-tax income or loss from continuing operations of the acquired business as compared to the absolute value of the pre-tax income or loss of the registrant; *and* (ii) the registrant's proportionate share of consolidated total revenue from continuing operations (after intercompany eliminations) of the acquired business as compared to consolidated total revenue of the registrant. Registrants may use the lower of the two components to determine the number of periods of Rule 3-05 financial statements to file.

Can pro forma financial information be used to test “significance”?

Yes, pro forma financial information can be used to test significance after the latest fiscal year-end if it only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end and includes only Transaction Accounting Adjustments, as defined in Rule 11-02. In addition, the registrant must have filed all audited financial statements for those acquisitions and dispositions, as required under Rule 3-05 or Rule 3-14. Management’s Adjustments for related synergies and dis-synergies of the acquisition or disposition, which may be presented at management’s discretion under certain circumstances, and Autonomous Entity Adjustments are not permitted for this purpose.

Prior to the amendments, the SEC staff only permitted the use of pro forma financial information to measure significance if the pro forma financial information related to a significant acquisition after fiscal year-end and the registrant filed its Rule 3-05 or Rule 3-14 financial statements and pro forma financial information on Form 8-K. Accordingly, pro forma financial information filed with an IPO registration statement could not be used to measure significance for subsequent acquisitions and dispositions. By eliminating the Form 8-K filing requirement, the amended rules now permit a registrant to use pro forma financial information filed in a registration statement – including an IPO registration statement – to test significance of subsequent acquisitions and dispositions.

Once a registrant has used pro forma amounts to determine significance of an acquisition or disposition, it must continue to use pro forma amounts to determine significance of acquisitions and dispositions through the filing date of its next annual report on Form 10-K.

What are “related acquisitions” and how are groups of related acquisitions treated for purposes of measuring significance?

Groups of related acquisitions are treated as a single acquisition. For these purposes, acquisitions are related if: (i) they are under common control or management; (ii) the acquisition of one real estate operation is conditional on the acquisition of each other real estate operation; or (iii) each acquisition is conditioned on a single common event. Any required financial statements for related acquisitions may be presented on a combined basis for any periods that related acquisitions are under common control or management.

Are financial statements still required once the operating results of the acquisition have been reflected in the audited consolidated financial statements of the REIT?

Generally the answer is no, but it depends on how long the acquisition has been reflected in the audited consolidated financial statements. Separate financial statements of an acquired real estate operation required under Rule 3-14 may be omitted once the operating results of the acquired real estate operation have been reflected in the audited consolidated financial statements of the REIT for at least nine months. Prior to the amendments, this provision was not applicable to acquisitions of real estate operations.

The same requirements apply to acquisitions of any other business subject to Rule 3-05 that does not exceed 40% significance. However, for individual acquisitions subject to Rule 3-05 that exceed 40% significance, the operating results of the acquired business must be reflected in the audited consolidated financial statements of the REIT for a complete fiscal year before separate financial statements are no longer required.

Are the requirements any different for an acquisition of real estate operations from a related party?

Not anymore. Prior to the amendments, three years of audited financial statements were required for significant real estate operations acquired from related parties. As amended, Rule 3-14 no longer distinguishes between acquisitions of real estate operations from related parties and all other acquisitions. In all cases, only one year of financial statements are required for significant acquisitions under Rule 3-14.

Are the requirements any different for an acquisition of a triple net leased property?

Not anymore. Prior to the amendments, for the acquisition of a real estate operation that was triple net leased (*i.e.*, the lessee is required to pay costs normally associated with ownership of the property such as property taxes, insurance, utilities and maintenance costs) to a single tenant, SEC staff guidance directed registrants to provide full audited financial statements of the lessee or guarantor under certain circumstances, instead of the audited financial statements of the property. The adopting release makes clear that, following the amendments, acquired triple net leased properties will be treated the same as any other acquired real estate operation, and lessee financial statements will not be required.

What information must be included in the audited financial statements for an acquired property?

Following the amendments, Rule 3-14 continues to permit abbreviated financial statements for acquisitions of real estate operations, which may be limited to statements of revenue and expenses, excluding expenses not comparable to the proposed future operations, such as mortgage interest, leasehold rental, depreciation, corporate expenses, and federal and state income taxes.

By contrast, Rule 3-05 requires the registrant to file full financial statements for acquired businesses that are significant. Abbreviated financial statements may, however, be permitted for an acquisition of net assets that constitutes a business (*e.g.*, an acquired or to-be-acquired product line) under certain circumstances.

Can financial statements covering a period of nine to 12 months be deemed to satisfy the requirement for filing financial statements of acquired real estate operations covering a period of one year?

Yes, following the amendments. Prior to the amendments, this accommodation applied only to financial statements under Rule 3-05.

Are there different requirements for smaller reporting companies?

No. The amendments eliminated the separate detailed disclosure requirements for acquisitions by smaller reporting companies. As amended, the rules applicable to smaller reporting companies now simply cross-reference the requirements under Rules 3-05 and 3-14, as applicable, to determine when financial statements and pro forma financial information are required. However, Rules 8-02 and 8-03, which govern the form and content of financial statements for smaller reporting companies, continue to apply.

Are there any different requirements for REIT formation transactions?

The adopting release did not address existing SEC guidance that provides a modified significance test for a REIT effecting a series of "formation transactions" in connection with its IPO. Under this guidance, the registrant may compute significance using a denominator equal to the total cost of (i) properties acquired immediately prior to filing the registration statement, (ii) properties to be acquired upon closing the IPO, and (iii) properties identified as probable future acquisitions. Additionally, in connection with formation transactions, an acquired business may be designated as a predecessor of a registrant when the registrant succeeds to substantially all of the business of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired. In these circumstances, different financial statements are required for acquisition of a predecessor, and the adopting release confirmed that the amendments do not affect those requirements.

Are there any different requirements for non-traded REIT IPOs?

Yes, but it depends on whether the acquisition occurs during or after the distribution period, which is the period during which the non-traded REIT is conducting a continuous registered initial public offering.

Because a non-traded REIT typically starts its "blind pool" initial public offering without any assets, virtually all acquisitions in the early stages of the offering (which can go on for years) would be significant if measured against total assets. To address this anomaly, the amendments codified SEC staff guidance to provide a modified significance test that applies to these offerings. Specifically, the significance of an acquisition during the initial distribution period is measured against the sum of (i) total assets as of the date of the acquisition, and (ii) offering proceeds (net of commissions) that the REIT expects in good faith to raise over the next 12 months.[6] After the distribution period ends and until the next Form 10-K is filed, the significance of an acquisition is measured against the REIT's total assets as of the date of acquisition or disposition, except that, for acquisitions, total assets must exclude the acquired business. Once the next Form 10-K is filed, no special significance measures apply.

Moreover, during the distribution period, the REIT must file a sticker supplement describing each significant acquisition not identified in the prospectus when it becomes reasonably probable that the acquisition will be completed. At least once every three months, the REIT must consolidate all sticker supplements into a post-effective amendment to the registration statement that must include or incorporate by reference all financial statements required to be filed under Rule 3-14 (or Rule 3-05, depending on the type of property acquired) for all significant properties acquired during the distribution period.

Prior to the amendments, for a non-traded REIT that acquired a hotel, nursing home or another type of property subject to Rule 3-05, all three significance tests (*i.e.*, investment, asset and income) applied using the modified significance test described above. Following the amendments, the income test does not apply in these circumstances.

The modified significance test applicable to non-traded REITs also applies to other registrants that are subject to the Item 20.D undertakings of Industry Guide 5.

What are the requirements for reporting significant acquisitions under Form 8-K?

As a general rule, for any completed acquisition (or group of related acquisitions) that is significant, a registrant must file a report on Form 8-K within four business days reporting the completion of the acquisition. The financial statements and pro forma financial information are not required to be filed on Form 8-K until 71 days after the initial report on Form 8-K must be filed (*i.e.*, approximately 75 days after the acquisition is completed). Also, a registrant that omits financial statements of a recently consummated acquisition from its initial registration statement because of the 74-day grace period must file those financial statements and any required pro forma information on Form 8-K no later than 75 days after consummation of the acquisition.

This general rule was not affected by the amendments.

What are the requirements for reporting significant dispositions and how did the amendments affect them?

As a general rule, for any disposition that is significant, pro forma financial information is required in a registration statement or proxy statement and the same pro forma financial information must be filed on Form 8-K when completion of the disposition is first reported (*i.e.*, four business days after the disposition is completed). The amendments raise the significance threshold for the disposition of a business from 10% to 20% to conform to the threshold for the acquisition of a business. The tests used to measure whether dispositions of businesses other than real estate operations are significant are the same tests used to measure whether acquisitions are significant. For real estate operations, however, all three significance tests (*i.e.,* investment, asset and income) are applicable to dispositions whereas only the investment test is applicable to acquisitions.

What are the requirements for reporting the acquisition or disposition of an asset that is *not* a business and how did the amendments affect them?

REITs and other registrants may also acquire or dispose of assets that do *not* meet the requirements to be considered a business (*i.e.,* there is not sufficient continuity of the entity's operations prior to and after the transaction to make disclosure of prior financial information material to an understanding of future operations). In those circumstances, the determination of whether the acquisition or disposition is significant (and therefore reportable under Item 2.01 of Form 8-K) is based on whether the equity in the net book value of the assets or the amount paid or received for the assets upon the acquisition or disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries.

This general rule was not affected by the amendments.

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[1] SEC Release No. 33-10786; 34-88914 (May 21, 2020), available at https://www.sec.gov/rules/final/2020/33-10786.pdf.

[2] SEC - Div. of Corp. Fin., Financial Reporting Manual, § 2300, available at https://www.sec.gov/corpfin/cf-manual.

[3] This general rule applies to any registration statement for an offering of securities (including shelf takedowns), any proxy statement where financial statements are required and any registration statement for a "spin-off" distribution of shares of a subsidiary, subject to certain exceptions. These requirements do not apply to registrations on Form S-8 and different requirements may apply to registrations on Form S-4 in connection with an acquisition. There are also some different requirements for certain special types of issuers, such as foreign private issuers and shell companies.

[4] Prior to the amendments, if the aggregate of all insignificant acquisitions subject to Rule 3-05 exceeded 50% significance, SEC staff guidance directed the registrant to provide financial statements for the mathematical majority of those acquisitions (including insignificant acquisitions).

[5] Rule 1-02(w) specifies a different significance test for a combination between entities or businesses under common control.

[6] In making this estimate, the REIT should consider the pace of fundraising as of the measurement date, the sponsor or dealer-manager's prior public fundraising experience and offerings by similar companies.

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