SEC Amends Rules to Streamline Financial Disclosure Requirements for Issuers and Guarantors of, and Issuers of Securities Collateralizing, Registered Debt Securities

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On March 2, 2020, the Securities and Exchange Commission (the "SEC") adopted amendments to the financial disclosure requirements in Rules 3-10 and 3-16 of Regulation S-X applicable to issuers and guarantors of registered debt securities and issuer affiliates whose securities collateralize registered debt securities.[1] According to the SEC, the amendments are intended to increase the likelihood that issuers will conduct certain guaranteed and collateralized debt offerings on a registered basis by reducing the costs and burdens of compliance, while assuring that investors receive relevant material information.

The amendments are predicated on a basic conceptual view (widely supported by commenters, including Cravath, on the proposed rules) that a parent company's consolidated financial information, together with supplemental information about structural subordination (in the case of guaranteed securities) and collateral (in the case of secured securities), is sufficient to permit a prospective investor to make an informed investment decision. We believe this conceptual view is supported by, among other things, the wide acceptance of streamlined disclosure consistent with this approach that is customary in the Rule 144A market.

The amendments:

- Expand the circumstances in which separate financial statements for subsidiary issuers and guarantors of registered debt securities are not required to be filed;
- Streamline the alternative financial disclosure required for subsidiary issuers and guarantors whose separate financial statements have been omitted and specify certain required alternative non-financial disclosures;
- Require the alternative disclosures to be included in the parent company's periodic reports required by the Securities Exchange Act of 1934, as amended (the "Exchange Act"), only for as long as the applicable issuer or guarantor has a reporting obligation under the Exchange Act with respect to the debt securities rather than for as long as the debt securities are outstanding; and
- Make similar modifications to the requirement for separate financial statements for issuer affiliates whose securities are pledged as collateral for registered debt securities and provide for alternative disclosures in lieu thereof.

This memorandum outlines the final rules and other guidance contained in the SEC's adopting release. The final rules will be effective on January 4, 2021 but, importantly, voluntary compliance will be accepted by the SEC prior to such date.

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[1] *Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities*, SEC Release No. 33-10762; 34-88307 (Mar. 2, 2020).

ISSUERS AND GUARANTORS OF REGISTERED DEBT SECURITIES

Background

Rule 3-10 requires each issuer of a registered security that is guaranteed and each guarantor of a registered security to file the financial statements required for a registrant by Regulation S-X, unless one of five exceptions to this general rule is satisfied and certain alternative disclosures are provided in lieu of separate financial statements. The amendments to Rule 3-10 affect (1) the issuer and guarantor structures that are eligible for an exception to the general rule, (2) the conditions that must be satisfied in order to omit separate financial statements, (3) the form and content of alternative disclosures and (4) the duration of the continuing Exchange Act reporting obligations of issuers and guarantors in respect of the alternative disclosures. The required alternative disclosures set forth throughout existing Rule 3-10 will be relocated to new Rule 13-01.

Eligible Structures

As amended, Rule 3-10 will permit the omission of separate financial statements for issuers and subsidiary guarantors of debt and debt-like securities[2] featuring one of the following issuer and guarantor structures:

- A parent company[3] issues the security or co-issues the security, on a joint and several basis, with one or more of its consolidated subsidiaries; or
- A consolidated subsidiary of the parent company issues the security, or co-issues it with one or more other consolidated subsidiaries of the parent company, and the security is fully and unconditionally guaranteed by the parent company.[4]

The above categories cover the full range of structures that are eligible for the omission of separate issuer and guarantor financial statements under existing Rule 3-10, but expand eligibility to include structures where subsidiary guarantees are not full and unconditional, including where the debt security provides for the release of subsidiary guarantees in certain circumstances. In addition, although we have not seen widespread inclusion of non-U.S. subsidiary guarantors in debt offerings by domestic issuers despite the relief from the historically adverse tax consequences associated with foreign guarantees, the new rules will further enhance the possibility of inclusion of non-U.S. guarantors because applicable local law in certain non-U.S. jurisdictions has historically prevented guarantees by entities organized in those jurisdictions from satisfying the "full and unconditional" requirement. The same conditions for the provision of alternative disclosures in lieu of separate issuer and/or guarantor financial statements will apply to all eligible structures.

Conditions

Under the final rule, in addition to the aforementioned eligibility requirements, the following conditions must be met:

- The parent company's consolidated financial statements must be included or incorporated by reference in the relevant filing, consistent with existing Rule 3-10; and

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[2] As amended, Rule 3-10 states that a guaranteed security will be considered "debt or debt-like" if the issuer has a contractual obligation to pay a fixed sum at a fixed time and, where the obligation to make such payments is cumulative, a set amount of interest must be paid. Consistent with the amendments to Rule 3-10 adopted by the SEC on August 4, 2000, the substance of the obligation created by the security, rather than its form or title, determines whether the security is debt or debt-like. See *Financial Statements and Periodic Reports for Related Issuers and Guarantors*, SEC Release No. 33-7878 (Aug. 4, 2000) (the "2000 Adopting Release").

[3] As amended, Rule 3-10 defines "parent company" as an entity that (1) is an issuer or guarantor of the guaranteed security, (2) is or will become an Exchange Act reporting company and (3) consolidates each subsidiary issuer and/or guarantor in its consolidated financial statements. This amendment is consistent with the definition of "parent company" provided in the 2000 Adopting Release, except that it has been modified to reflect the final rule's inclusion of all consolidated subsidiaries in the issuer and guarantor structures eligible for relief.

[4] A guarantee may be deemed full and unconditional for purposes of Rule 3-10 notwithstanding the existence of customary arrangements that provide for a release of the guarantee, including, for example, the sale of the guarantor or all of its assets or the conversion of the applicable debt securities into equity securities. See *Division of Corporation Finance, Financial Reporting Manual*, Sections 2510.4-5 (Jul. 1, 2019).

- A subsidiary issuer or guarantor whose separate financial statements are being omitted must be a consolidated subsidiary of the parent company.

The amended conditions expand the universe of subsidiary issuers and guarantors eligible for relief beyond the scope of existing Rule 3-10, which limits eligible subsidiary issuers or guarantors to entities that are 100% owned by the parent company and excludes entities that have issued securities convertible into their own voting shares.

Required Alternative Disclosures

In the event that a subsidiary issuer's or guarantor's separate financial statements are omitted, the final rules require, if material, streamlined alternative financial and non-financial disclosures aimed at allowing investors to evaluate the sufficiency of the guarantee (*i.e.*, the structural subordination risk presented by the structure of the relevant security, rather than the financial ability of any individual subsidiary guarantor to make payment under its guarantee).

Under the final rule, the required alternative financial disclosures for subsidiary issuers and guarantors will include summarized financial information[5] for the most recently ended fiscal year and year-to-date interim period,[6] as well as disclosure, in separate line items, of amounts due from or to, and transactions with, non-obligor subsidiaries and other related parties. This summarized financial information:

- Must entirely exclude all financial information of non-issuer and non-guarantor subsidiaries, meaning that, consistent with accepted market practice in offerings under Rule 144A, an issuer or guarantor would not present its investments in non-issuer or non-guarantor subsidiaries in the summarized financial information even if it would have done so under otherwise applicable accounting methods;
- May be presented on a combined basis for all issuers and guarantors of the applicable security (subject to certain circumstances, discussed below, in which a disaggregated presentation may be required), in which case all intercompany balances and transactions between obligors whose information is presented on a combined basis must be eliminated; and
- Must include summarized financial information for a recently acquired subsidiary issuer or guarantor if the acquired business is "significant" using the significance test for acquired businesses under Rule 3-05 of Regulation S-X.[7] This requirement—while significantly less burdensome than the prior rules for a recently acquired subsidiary issuer

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[5] New Rule 13-01 requires, for each issuer and guarantor, the presentation of the summarized financial information specified in Rule 1-02(bb)(1) of Regulation S-X, which includes certain balance sheet and income statement line items, as well as an accompanying note that briefly describes the basis of presentation. Generally, such line items include current and non-current assets and liabilities, redeemable preferred stock and non-controlling interests (if applicable), gross revenue/net sales, gross profit, income from continuing operations, net income and net income attributable to the reporting entity. This amendment reduces the burden of compliance by eliminating the existing requirement to present all major captions of the three financial statements that are required to be presented in accordance with Article 10 of Regulation S-X. Notably, no statement of cash flow information is required.

[6] New Rule 13-01 eliminates the existing requirement to present alternative disclosure information as of, and for, the two fiscal years preceding the most recently ended fiscal year and the quarter-to-date interim period.

[7] Rule 3-05 provides for use of a 20% significance threshold for acquired businesses rather than the 10% threshold indicated in Rule 1-02(w) for determining whether a subsidiary is significant. The SEC has proposed amendments to Rule 3-05 that would affect the determination of whether an acquired business is significant. See *Amendments to Financial Disclosures About Acquired and Disposed Businesses*, SEC Release No. 34-85765 (May 3, 2019). If the amendments modifying the significance tests in Rule 3-05 are adopted, the tests for determining whether a recently acquired subsidiary issuer or guarantor is significant for purposes of Rule 3-10 will change correspondingly.

If a subsidiary issuer or guarantor is acquired after the parent company's most recent balance sheet date and a registered securities offering under the Securities Act of 1933, as amended ("Securities Act"), is contemplated, new Rule 13-01 requires separate summarized financial information for the newly acquired subsidiary issuer or guarantor to be provided in a Securities Act registration statement, but not in subsequent Exchange Act reports.

or guarantor—nevertheless may result in pre-acquisition summarized financial information being required for an entity before its financial statements are required to be filed under Rule 3-05.[8]

While summarized financial information may be provided on an aggregate basis for all issuers and guarantors, in the event that any of the non-financial disclosure described below applies to some, but not all, issuers or guarantors (for example, where some, but not all, guarantees are subject to release provisions or a guarantor is less than wholly owned by the parent company), separate disclosure of summarized financial information will be required for the issuers and guarantors to which such non-financial disclosure applies, to the extent material.[9] In limited instances, narrative disclosure in lieu of separate summarized financial information may be sufficient.[10]

In addition to the summarized financial information, the alternative disclosures must include certain non-financial disclosures, such as:

- The identification of the issuers and guarantors of each guaranteed security, which may be provided in an exhibit to periodic Exchange Act reports;[11]
- A description of the terms and conditions of the guarantees, including any way in which the guarantees are not full and unconditional, such as any applicable release provisions;
- A description of any material factors that may affect payment on the guarantees, including the rights of holders of non-controlling interests in a guarantor or contractual or statutory restrictions on dividends by a guarantor; and
- The disclosure of any additional information that would be material to an investor's evaluation of the sufficiency of the guarantee and necessary to make the presentation of the alternative disclosures not misleading.

Significantly, the final rule eliminates the requirement for separate disclosure of the financial information of non-guarantor and non-issuer subsidiaries.

The final rule also identifies four non-exclusive safe harbors pursuant to which summarized financial information may be omitted on the basis that it is not material, given the inclusion of the parent company's consolidated financial statements:

- The assets, liabilities and results of operations of the combined issuers and guarantors of the guaranteed security are not materially different from corresponding amounts presented in the consolidated financial statements of the parent company;[12]
- The combined issuers and guarantors, excluding investments in subsidiaries that are not issuers or guarantors, have no material assets, liabilities or results of operations;

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[8] For example, Rule 3-05(b)(4) permits pre-acquisition financial statements of an acquired business to be omitted from a registration statement or proxy statement if the significance of the acquisition does not exceed 50%, the registration statement is declared effective or the mailing date of the proxy statement is no more than 74 calendar days after the acquisition has been consummated, and the financial statements of the acquired business have not been previously filed.

[9] The SEC states that a parent company should consider materiality and exercise judgment in determining the appropriate level of aggregation based on quantitative and qualitative factors that include the financial significance and facts and circumstances of the applicable issuers and guarantors.

[10] For example, narrative disclosure may be sufficient when the separate financial information of the applicable issuers and guarantors can be easily explained and understood, for example, when a subsidiary guarantor constitutes a similar percentage of assets, liabilities and operations of the obligor group.

[11] Amended Item 601(a) and new Item 601(b)(22) of Regulation S-K permit the list identifying the issuers and guarantors of each guaranteed security to be filed as an exhibit to the parent company's periodic Exchange Act reports, which may be incorporated by reference (if unchanged) for ongoing compliance.

[12] This safe harbor does not apply if separate disclosure of summarized financial information applicable to one or more, but not all, issuers or guarantors is required as described above.

- The sole issuer is a finance subsidiary[13] of the parent company, and no other subsidiary of the parent company guarantees the security; or
- The issuer is a finance subsidiary that co-issued the security, jointly and severally, with the parent company, and no other subsidiary of the parent company guarantees the security.

Although the SEC believes these scenarios encompass most of the situations under which summarized financial information would be not material, the safe harbors are non-exclusive. The general materiality provision of new Rule 13-01 affords the parent company wide discretion to conclude, based on the facts and circumstances of a scenario that does not fall within a safe harbor, that all or a portion of the summarized financial information is not material and may, therefore, be omitted.

Location of Alternative Disclosures

The final rule permits the parent company to provide the alternative disclosures, at its option, in the footnotes to its consolidated statements, in its Management's Discussion and Analysis ("MD&A"), in a prospectus immediately following "Risk Factors", if any, or with pricing information described in Item 105 of Regulation S-K. Unlike existing Rule 3-10, which requires the guarantor / nonguarantor financial information to be included in a note to the parent company's financial statements (and thus subject to auditor review or audit, as applicable), if the alternative disclosures are not provided in the parent company financial statements, the information will not need to be audited. We believe that the flexibility to include this information in the MD&A or otherwise outside the financial statements is one of the more attractive aspects of the new rules, significantly reducing the burden associated with audit requirements.

Ongoing Reporting of Alternative Disclosures

Existing Rule 3-10 requires the alternative disclosures to be included in the parent company's Exchange Act periodic reports for as long as the guaranteed securities are outstanding, even if the issuer's and guarantor's reporting obligations under the Exchange Act with respect to those securities have been suspended. By contrast, amended Rule 3-10 permits a parent company to cease providing alternative disclosures at the time the applicable issuer or guarantor no longer has a reporting obligation under the Exchange Act with respect to those securities. This change is unlikely to practically affect a frequent issuer of registered debt securities with subsidiary issuers or guarantors as the parent company likely will wish to maximize potential speed to market by remaining current with the alternative disclosures. If, however, the terms of an issuer's outstanding debt securities do not contractually impose additional disclosure requirements for subsidiary issuers and guarantors, a parent company that is an infrequent issuer of registered debt securities with subsidiary issuers or guarantors may benefit significantly from this change as it would allow the parent company to omit alternative disclosures from its periodic reports after the first annual report on Form 10-K following the issuance of the applicable debt security (assuming the securities are held by fewer than 300 holders).

ISSUER AFFILIATES WHOSE SECURITIES ARE PLEDGED AS COLLATERAL FOR REGISTERED DEBT SECURITIES

The changes to the requirements in existing Rule 3-16 for separate financial statements for issuer affiliates whose securities are pledged as collateral for registered debt securities pursuant to the final rules establish a disclosure framework that is largely analogous to the changes discussed above with respect to issuers and guarantors of guaranteed registered debt securities, with required alternative disclosures relocated from Rule 3-16 to new Rule 13-02. The requirement in existing Rule 3-16 to provide separate financial statements for such issuer affiliates when the aggregate principal amount, par value or book value of the pledged affiliate securities constitutes more than 20% of the principal amount of the debt securities secured thereby is replaced with a requirement to provide the alternative disclosures in all cases, to the extent material. Compliance with the final rule will not be required for debt securities issued by issuers

[13] For purposes of the safe harbors, new Rule 13-01 defines a "finance subsidiary" as a subsidiary that has no assets or operations other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company. This definition is consistent with the existing definition in Rule 3-10, except that the new definition excludes references to "revenues", which are covered by the reference to "operations", and "cash flows", as cash flow information is no longer a required financial disclosure.

that were not required to file Rule 3-16 financial statements prior to the effective date of the final rule if the relevant securities include provisions requiring the release of the applicable collateral if separate financial information would be required under Rule 3-16. This last provision was added in response to concerns expressed when the new rules were proposed that the new rules might allow an existing issuer to release guarantors solely as a result of the rule change with a resulting substantive impact on the collateral package at the time of the rule change.

FOREIGN PRIVATE ISSUERS

Similar to domestic issuers, foreign private issuers will be required to comply with new Rules 13-01 and 13-02 and will continue to be required to comply with amended Rules 3-10 and 3-16. However, given differences between foreign and domestic forms required by the Exchange Act and the Securities Act of 1933, as amended, some of the requirements are located in different places, such as through amendments to the instructions to Forms F-1, F-3 and 20-F, when applied to foreign private issuers.

CONCLUDING THOUGHTS

These amendments represent a significant and welcome streamlining of the disclosure obligations in respect of issuers and guarantors of guaranteed registered debt securities. Given the widespread market acceptance of Rule 144A (and, particularly, Rule 144A-for-life) transactions, it remains to be seen whether these changes will have a meaningful impact on the willingness of issuers to register offerings of guaranteed debt securities that may have otherwise been conducted on an unregistered basis. It is also possible that issuers who are contemplating offerings of registered debt securities on a nonguaranteed basis may be more willing to provide subsidiary guarantees if offering the debt securities on a guaranteed basis would improve execution. Although the amendments are not effective until January 4, 2021, given the reduced cost and burden of compliance under the amended rules, we expect issuers and guarantors of registered debt securities to begin adapting their internal and disclosure controls and procedures in preparation for voluntary compliance in the near term.

Please feel free to contact us if we can provide further information on these matters.

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