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Legal Update
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SEC Proposes Amendments to Financial Statement Disclosure Requirements in Rules 3-10 and 3-16 of Regulation S-X

On July 24, 2018, the US Securities and Exchange Commission (SEC) proposed amendments to the financial disclosure requirements in Rules 3-10 and 3-16 of Regulation S-X, in an effort to simplify and streamline disclosures by registrants in registered debt offerings with respect to guaranteed or collateralized debt securities. Rule 3-10 addresses the financial disclosure requirements for guarantors and issuers of guaranteed securities, while Rule 3-16 focuses on financial disclosure requirements for affiliates whose securities constitute a substantial portion of the collateral for securities offered. Both sets of disclosure requirements affect not only the issuer's offering documents, but also its periodic filings. The SEC stated that the proposed amendments are "intended to provide investors with material information given the specific facts and circumstances, make the disclosures easier to understand, and reduce the costs and burdens to registrants."

The review of the requirements and proposed amendments to Rule 3-10 and 3-16 stem from the SEC's Disclosure Effectiveness Initiative. The proposed rules follow the SEC's 2015 request for comments on these requirements.

Rule 3-10

Rule 3-10 generally requires a registration statement to include Regulation S-X compliant financial statements which include audited annual and unaudited interim financial statements for the issuer and guarantor(s) of the securities being registered.[1] This requirement flows from the position that a guarantee is a separate security from the guaranteed obligation and thus the guarantor's credit worthiness must be able to be evaluated separately from that of the issuer of the guaranteed obligation. Under the current Rule 3-10, in order to omit separate subsidiary issuer or guarantor financial statements, a subsidiary or guarantor must be wholly owned by the parent company and the guarantee must be full and unconditional. A subsidiary issuer or guarantor eligible to omit separate financial statements also is exempt from the periodic reporting requirements under the Securities Exchange Act of 1934 (Exchange Act). If the conditions for omission are met, alternative disclosures, which may include condensed consolidating financial information or narrative disclosure, must be provided by the parent company in its financial statements for so long as the guaranteed securities are outstanding. There is also a requirement for recently acquired subsidiaries that are "significant" (under Rule 1-02(w) of Regulation S-X) for the issuer to file audited financial statements for that subsidiary. As issuers of registered debt already know, compliance with the requirement to present consolidating information is time-consuming and costly. The approach underlying the current requirements is premised on the notion that investors in guaranteed debt securities will base their investment decisions on the parent's

consolidated financial statements. The current requirements and the application of the permitted exceptions may result in burdensome disclosure requirements and the resulting detail may not be helpful to investors and in fact may obscure the information that is material to an investment decision.

The proposed amendments include amending both Rule 3-10 and 3-16 and relocating part of Rule 3-10 and all of Rule 3-16 to new Article 13 in Regulation S-X, which would comprise proposed Rules 13-01 and 13-02. Proposed Article 13 would contain financial and non-financial disclosure requirements for certain types of securities registered or being registered that, while material to investors, need not be included in the audited and unaudited financial statements.

Proposed Amendments to Rule 3-10/ Partial Relocation to Rule 13-01

The proposed amendments to Rule 3-10 preserve the ability to omit separate subsidiary issuer or guarantor financial statements when certain conditions are met with some modifications to the current conditions and simplify the requirements relating to consolidating financial information.

As proposed, the separate financial statement requirement could be omitted if the consolidated financial statements of the parent company have been filed; the subsidiary issuer or guarantor is a consolidated (rather than wholly-owned) subsidiary of the parent company; the guaranteed security is a debt security; and one of the following issuer-guarantor structures is used: (x) the parent company issues or co-issues the security, jointly and severally, with one or more of its consolidated subsidiaries; or (y) a consolidated subsidiary issues or co-issues the security with one or more other consolidated subsidiaries of the parent company, and the security is guaranteed fully and unconditionally by the parent company.

The proposed amendments also would:

- Modify the requirement that the parent company[2] owns, directly or indirectly, 100 percent of each subsidiary issuer and guarantor. Instead, this prong would be replaced with a requirement that the entity consolidate each subsidiary issuer and guarantor in its financial statements in order to be considered the "parent company."
- Permit subsidiaries that are not wholly owned, but the financial results of which are consolidated, to be eligible to omit separate financial statements. Additional disclosures regarding risks associated with non-controlling interest holders would be required.
- Provide guidance regarding when a guaranteed security is considered "debt or debt-like" (which includes preferred stock that have payment terms that are substantially the same as debt).
- Simplify the issuer-guarantor structures that are eligible for alternative disclosures in the following two categories: (x) the parent company issues or co-issues the security, jointly and severally, with one or more of its consolidated subsidiaries, or (y) a consolidated subsidiary issues or co-issues with one or more other consolidated subsidiaries of the parent company, and the security is fully and unconditionally guaranteed by the parent company. In line with the SEC's belief that the parent company's consolidated financial statements serve as the primary source of information for investors, the proposed amendments focus on whether the parent company's obligations with respect to the debt security in its role as issuer, co-issuer or guarantor are full and unconditional.
- The requirements for proposed alternative disclosures (provided in place of consolidating financial information) would be relocated and the requirements relating to consolidating information would be

simplified (summarized financial information would be required, which is more streamlined) and the periods required to be presented would be pared back to the most recently completed fiscal year and the year-to-date interim period.

- Certain non-financial disclosure requirements would be required to supplement the summarized financial information.
- The parent company would be allowed to decide whether to present the alternative disclosures in the notes to its financial statements or elsewhere in its registration statement and subsequent Exchange Act filings.

The requirements for the proposed alternative disclosures would be included in a single location within proposed Rule 13-01, rather than spread among the multiple subsections of existing Rule 3-10. The proposed amendments address also the application of the requirements to issuers of asset-backed securities, smaller reporting companies, and issuers undertaking Regulation A offerings.

Rule 3-16

Rule 3-16 requires a registrant to provide separate financial statements for each affiliate whose securities constitute a "substantial portion" of the collateral for any class of registered securities as if the affiliate were a separate registrant. An affiliate's portion of the collateral is considered a "substantial portion" if the value of the affiliate's securities (determined as the greatest of the aggregate principal amount, par value or book value of such securities or the market value of such securities) equals or exceeds 20 percent of the principal amount of securities registered or being registered. If the 20 percent "substantial portion" threshold is met, then the registrant must provide financial statements for that affiliate.

Proposed Amendments to Rule 3-16/ Relocation to Rule 13-02

The SEC proposed to amend the disclosure requirements in Rule 3-16 and relocate them to Rule 13-02 of the new Article 13 of Regulation S-X. Among other things, the proposed amendments would:

- replace the existing requirement to provide separate financial statements for each affiliate whose securities are pledged as collateral with a new requirement to provide financial and non-financial disclosures about the affiliate[s] and the collateral arrangement as a supplement to the consolidated financial statements of the registrant that issues the collateralized security;
- permit the proposed financial and non-financial disclosures to be located in filings in the same manner as described above for the disclosures related to guarantors and guaranteed securities as described in the proposed Rule 3-10 amendments; and
- replace the existing requirement to provide disclosure only when the pledged securities meet or exceed the 20 percent "substantial portion" test with a new requirement to provide the proposed financial and non-financial disclosures in all cases unless they are immaterial to holders of the collateralized security.

In particular, the new Rule 13-02 requires the following disclosures, to the extent they are material to holders of the collateralized security, to be provided: (1) a description of the security pledged as collateral and each affiliate whose security is pledged as collateral; (2) a description of the terms and conditions of the collateral arrangement; (3) a description of the trading market for the affiliate's security pledged as collateral or a statement that there is no market; (4) summarized financial information (as defined in Rule 1-02(bb)(1) of Regulation S-X) of each affiliate whose securities are pledged as collateral, which can be presented on a

combined basis; and (5) any other quantitative or qualitative information that would be material in making an investment decision with respect to the collateralized security.

The SEC's overarching principle with respect to these Rule 3-16 amendments is that the consolidated financial statements of the registrant are the most relevant information for investors when making investment decisions about the registrant's securities that are collateralized by securities of its affiliates.

The SEC observed that in practice, affiliates whose securities collateralize a registered security are almost always consolidated subsidiaries of the registrant, and such affiliates' financial information is already included in the registrant's consolidated financial statements. While information about such affiliates is material for an investor to consider potential outcomes in the event of foreclosure, the SEC believes that separate financial statements of each such affiliate are not material in most situations. Hence, the SEC reasoned, "the nature and extent of disclosures about the affiliate and the related collateral arrangement should be consistent with the supplemental nature of such information and balanced with the cost of providing such disclosure."

Practical Consequences and Implications for Issuers

In the proposing release, the SEC suggests that simplifying the requirements under Rule 3-10 may lead an issuer that might have been deterred from offering registered debt securities and would have relied on Rule 144A in order to avoid the burdensome consolidating information requirements to re-evaluate a registered issuance. Although the proposed Rule 3-10 amendments indeed simplify the structural requirements for eligibility to omit separate financial statements and the proposed summarized financial information would be a welcome change, a Rule 144A issuance is still a likely option where timing is a consideration (e.g., a guarantee is added at the last minute) and the pricing difference for a Rule 144A offering is less than the cost of compliance. That being said, the proposed amendments would provide an investor with the information material to an investment decision in guaranteed debt securities and eliminate overly detailed, prescriptive disclosures that many find difficult to understand.

The proposed Rule 3-16 amendments also are a welcome development for issuers contemplating registered debt offerings that include pledges of affiliate securities as collateral, and a welcome relief for those registrants subject to the existing Rule 3-16 requirements who have issued registered debt securities backed by pledges of affiliate securities as collateral.

Below, we highlight a few practical consequences, implications and reminders for issuers in relation to the SEC's proposed Rule 3-16 amendments.

First, the immediate positive benefit of the proposed Rule 3-16 amendments would be a reduction in the costs and burden of compliance associated with the preparation of full, separate, audited financial statements for each affiliate of the registrant that meets the 20 percent "substantial portion" test. As highlighted by the SEC in its proposing release, the SEC has received much feedback from various stakeholders that the preparation of these financial statements can be quite onerous, costly and time-consuming, so much so that issuers have historically structured their debt offerings to avoid or exclude pledges of affiliate securities, structured their deals as unregistered offerings, or specifically released an affiliate's securities from collateral if and when their inclusion would trigger the existing Rule 3-16 requirements. Replacing full financial statements with summarized financial information consisting of select balance sheet and income statement line items, as well as supplemental non-financial disclosures relating to the affiliates and the

collateral arrangements, would streamline the required disclosures and lower costs for issuers.

Second, the proposed Rule 3-16 amendments would provide debt issuers greater flexibility in pursuing transactions featuring these credit enhancements through an SEC-registered offering or a Rule 144A private placement. In order to avoid existing Rule 3-16 requirements, issuers have often opted to either privately offer collateralized securities through the Rule 144A private placement route or publicly offer registered securities that do not include pledges of affiliated securities as collateral. By simplifying the required financial disclosures in SEC-registered offerings and aligning those existing disclosures with the current disclosure practice in Rule 144A private placements, companies would be encouraged to offer collateralized securities on an SEC-registered basis and include pledges of collateral in their debt structures.

Third, issuers must be careful in conducting their materiality assessments under the proposed Rule 3-16 amendments. The 20 percent "substantial portion" test under existing Rule 3-16, even if burdensome, provided a bright-line test as to when affiliate financial statements would be required. In contrast, the new Rule 13-02 establishes a materiality test, such that investors should be provided with the required financial and non-financial disclosures to the extent material to holders of the collateralized security. On the whole, however, this materiality test would still be less burdensome for registrants than the numerical threshold test, and there is reason to believe that registrants would be familiar in making these kinds of materiality assessments in their registration statements and periodic filings under the Exchange Act.

Last, it is important to highlight that the simplified disclosures under the proposed Rule 3-16 amendments would equally apply to certain kinds of issuers such as foreign private issuers, smaller reporting companies, and issuers offering securities pursuant to Regulation A. In its proposing release, the SEC also proposed amendments to Form 20-F, Note 4 to Rule 8-01, and to Forms 1-A and 1-K to make the proposed changes applicable to these entities.

The proposed amendments to Rules 3-10 and 3-16 are open for public comment for a period of 60 days from their publication with the Federal Register.

As part of the proposing release, the SEC has prepared a table summarizing the main features of existing Rule 3-10 and Rule 3-16 and the proposed rules, a copy of which is available at https://goo.gl/Y3Ro91.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers or any other member of our Corporate & Securities practice.

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Endnotes

[1] There are five available exceptions in existing rules 3-10(b) through (f) relating to the following circumstances: (1) a finance subsidiary that issues securities that its parent company guarantees, (2) an operating subsidiary that issues securities that its parent company guarantees, (3) a subsidiary that issues securities that its parent company and one or more other subsidiaries of its parent company guarantees, (4) a parent company that issues securities that all of its subsidiaries guarantee, and (5) a parent company that issues securities that more than one of its subsidiaries guarantee.

[2] Under Section III.A.6 of the SEC's Release No. 33-7878 adopting financial reporting rules for related issuers and guarantors of guaranteed securities (issued in August 2000), for purposes of Rule 3-10, the parent company is the company that (i) is an issuer or guarantor of the subject securities; (ii) is, or as a result of the subject Securities Act registration statement will be, an Exchange Act reporting company; and (iii) owns 100 percent, directly or indirectly, of each subsidiary issuer and/or subsidiary guarantor of the subject security.