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Legal Update

SEC Amends Financial Disclosure Requirements in Registered Debt Offerings involving Guaranteed or Collateralized Securities

On March 2, 2020, the US Securities and Exchange Commission (SEC) adopted amendments to Rules 3-10 and 3-16 of Regulation S-X that simplify and streamline the financial disclosures required in registered debt offerings involving guaranteed or collateralized debt securities.[1]

Rule 3-10 addresses financial disclosure requirements for guarantors and issuers of guaranteed securities. Rule 3-16 focuses on financial disclosure requirements for affiliates the securities of which constitute a substantial portion of the collateral for the offered securities. The rules affect disclosures in connection with registration statements and offering documents, as well as in subsequent periodic reports filed by public companies under the Securities Exchange Act of 1934, as amended (Exchange Act). The amendments are intended to improve the quality of disclosure to investors and encourage issuers to conduct debt offerings that feature these credit enhancements on a registered, rather than on an exempt, basis. The SEC stated that these changes 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 amendments form part of the SEC's ongoing Disclosure Effectiveness Initiative and will be effective on January 4, 2021, but voluntary compliance ahead of that date is permitted.

Existing Rule 3-10

Existing Rule 3-10 generally requires each issuer and each guarantor of a registered debt security to file its own audited annual and unaudited interim financial statements that comply with the requirements of Regulation S-X, but provides several exceptions. Absent any exemption or relief, the registration statement must include the full financial statements of the issuer and the guarantors of the registered securities. This requirement flows from the position that a guarantee is a security separate and distinct from the debt being issued, and a potential investor must be able to evaluate the guarantor's creditworthiness separately from the debt issuer's creditworthiness. After the offer and sale of securities pursuant to a registration statement under the Securities Act of 1933, as amended (Securities Act), the issuer and the guarantors of the registered debt security would thereafter become subject to the ongoing SEC periodic reporting requirements under Section 15(d) of the Exchange Act, and these reports must also include annual and interim financial statements that comply with Regulation S-X.

Existing Rules 3-10(b) to (f) provide five different exceptions that permit a subsidiary issuer or guarantor to omit its financial statements from a registration statement and to be exempt from Exchange Act reporting obligations. To avail itself of an exception, the relationship of the guarantor and issuer must fall within any of the specified eligible issuer-guarantor structures[2] and certain specified conditions thereunder must be met. Notably, these conditions include that (1) consolidated financial statements of the parent company[3] have been filed, (2) each subsidiary issuer and guarantor must be "100%-owned" by the parent company, (3) each guarantee must be "full and unconditional" and, where there are multiple guarantees, joint and several, and (4) the parent company must provide certain prescribed alternative disclosures (Alternative Disclosures) in its consolidated financial statement footnotes, for so long as the guaranteed securities remain outstanding. The form and content of Alternative Disclosures are determined based on facts and circumstances relating to the issuer-guarantor structure and can take the form of a brief narrative disclosure,[4] or prescribed condensed consolidating financial information (Consolidating Information). As issuers of registered debt already know, the preparation of Consolidating Information is both time-consuming and costly. While short of full financial statements, Consolidating Information still includes all major captions of the balance sheet, income statement and cash flow statement that are required to be shown separately in interim financial statements under Article 10 of Regulation S-X.

Finally, existing Rule 3-10(g) requires a parent company to provide one year of pre-acquisition audited financial statements of a recently acquired subsidiary issuer or guarantor, where that subsidiary is "significant" (under Rule 1-02(w) of Regulation S-X) and the subsidiary is not reflected in the parent company's consolidated financial statements for a least nine months of the most recent fiscal year.

Existing Rule 3-16

Existing Rule 3-16 requires a registrant to provide separate audited annual and unaudited interim financial statements for each affiliate the securities of which 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 the securities registered or being registered. If the 20 percent "substantial portion" threshold is met, the registrant must provide full financial statements for such affiliate. Insofar as subsequent periodic reporting under the Exchange Act is concerned, Section 3-16 financial statements of each affiliate must be included in the parent company's annual reports, but are not required for its quarterly reports.

Problems Complying with Existing Rules

In connection with the SEC's July 2018 proposing release, SEC Chair Jay Clayton remarked that he has seen instances in which an issuer did not pursue SEC registration of a debt offering that included a subsidiary guarantee or pledge of affilitate securities as collateral because of the cost and time burdens associated with complying with current rules. We have also seen that, in practice, issuers have preferred to conduct Rule 144A offerings in order to avoid the burdensome requirements for SEC-registered deals. The SEC also observed that registrants have often structured or tweaked their debt agreements to release affiliate securities pledged as collateral – if the disclosure requirements of Rule 3-16 would be triggered – and this deprives investors of that collateral protection.

The final amendments are aimed at alleviating these problems. The amendments update both Rules 3-10 and 3-16 and relocate part of Rule 3-10 and all of Rule 3-16 to a new Article 13 in Regulation S-X.

Amended Rule 3-10 / New Rule 13-01

The final amendments to Rule 3-10 preserve a registrant's ability to omit separate subsidiary issuer and guarantor financial statements when certain conditions are met, with some modifications to the current conditions, and simplify the existing requirements relating to Consolidating Information. The final amendments:

- simplify the eligible issuer-guarantor structures and specified conditions to be met;
- replace the condition that a subsidiary issuer or guarantor be 100%-owned by the parent company with a condition that it be consolidated in the parent company's consolidated financial statements;
- replace the requirement for Consolidating Information with certain financial and non-financial disclosures (collectively, Revised Alternative Disclosures). In particular:
    - the amended financial disclosures consist of "Summarized Financial Information" (as defined in Rule 1-02(bb)(1) of Regulation S-X)[5] of the issuers and guarantors (excluding subsidiaries that are not issuers or guarantors), which may generally be presented on a combined basis, and reduce the number of periods required to be presented to the most recently completed fiscal year and the year-to-date interim period; and
    - the amended non-financial disclosures expand the qualitative disclosures about issuers and guarantors, terms and conditions of the guarantees and how the issuer-guarantor structure and other factors may affect payments to debt holders.
- permit the Revised Alternative Disclosures to be provided outside the footnotes to the parent company's audited annual and unaudited interim consolidated financial statements in the registration statement for the subject offering as well as subsequent periodic SEC filings;
- require the presentation of Revised Alternative Disclosures for so long as an issuer or guarantor has an Exchange Act reporting obligation with respect to the guaranteed securities rather than for so long as the guaranteed securities are outstanding; and
- eliminate the requirement to provide pre-acquisition financial statements of recently acquired subsidiary issuers and guarantors.

We describe these amendments in more detail below.

Simplified Eligibility Criteria and Conditions for Exemption. Instead of the five different issuer-guarantor eligible structures found in Existing Rule 3-10, the new rules use two broad categories for eligibility, *i.e.*, either: (x) the parent company issues the security or co-issues the security, jointly and severally, with one or more of its consolidated subsidiaries or (y) a consolidated subsidiary issues the security 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. In line with the SEC's view that the parent company's consolidated financial statements serve as the primary source of information for investors, the 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 conditions to rely on the exemption have also been simplified as follows and these will now be

situated in a single location within new Rule 13-01 rather than spread among the multiple subsections of existing Rule 3-10. These conditions are that (1) consolidated financial statements of the parent company have been filed, (2) the subsidiary issuer or guarantor is a consolidated subsidiary of the parent company, (3) the guaranteed security is debt or debt-like, (4) the issuer and guarantor structure must match one of the two eligible structures described above, and (5) the parent company provides Revised Alternative Disclosures.

Requring a Subsidiary to be "consolidated with" Instead of being "100%-owned by" the Parent Company. The amendments will modify the current requirement that the parent company owns, directly or indirectly, 100 percent of each subsidiary issuer and guarantor. Instead, amended Rule 3-10(a) requires that the subsidiary issuer or guarantor be a consolidated subsidiary of the parent company pursuant to the relevant accounting standards already in use. The "parent company" definition is also modified such that, to be considered a "parent company," the entity must consolidate each subsidiary issuer and/or guarantor in its consolidated financial statements.

The SEC noted that the existence of non-controlling interest holders alone generally does not alter the fundamental nature of the investment and, as long as the parent company is obligated as an issuer or as a full and unconditional guarantor and it controls and includes the subsidiary issuer or guarantor in its consolidated financial statements, then sufficent "financial unity" exists between the parent company and the related subsidiary that investors can evaluate and assess. New Rule 13-01 would, however, require a description of any factors that may affect payments to holders of the guaranteed security, such as the rights of a non-controlling interest holder, as well as additional disclosures regarding risks associated with non-controlling interest holders.

Revised Alternative Disclosures. Consolidating Information will be replaced by the shorter, abbreviated Summarized Financial Information and certain non-financial disclosure about issuers and guarantors.

Summarized Financial Information includes select (instead of all major captions of) balance sheet and income statement line items and an accompanying note that briefly describes the basis of presentation, but unlike Consolidating Information, excludes cash flow statement items. Summarized Financial Information of the subsidiary issuer or guarantor may be presented on a combined basis with the Summarized Financial Information of the parent company, and will cover only the most recently ended fiscal year and year-to-date interim period included in the parent company's financial statements. Disclosure of financial information of subsidiaries that are neither issuers nor guarantors will not be required by the amended rule. In contrast, Consolidating Information under existing Rule 3-10 requires separate columnar presentation of information regarding the parent company, subsidiary issuers and guarantors, and other subsidiaries on a consolidated basis, covering the same periods as the parent company's consolidated financial statements.

New Rule 13-01 expands the qualitative disclosures about issuers and guarantors, terms and conditions of the guarantees and how the issuer-guarantor structure and other factors may affect payments to debt holders. The new rule will also require disclosure of any financial and narrative information about each guarantor if the information would be material[6] for investors to evaluate the sufficiency of the guarantee and require disclosure of sufficient information so as to make the financial and non-financial information presented not misleading. Revised Alternative Disclosures will be required in all cases, to the extent material.

Location and Audit Requirement for Revised Alternative Disclosure vs. Alternative Disclosures. New Rule 13-01 will permit the parent company to provide the Revised Alternative Disclosures in a

footnote to its consolidated financial statements or alternatively, in the Management's Discussion and Analysis (MD&A). If not otherwise included in the consolidated financial statements or in the MD&A, the parent company will be required to include the Revised Alternative Disclosures in its prospectus immediately following "Risk Factors" or otherwise, immediately following pricing information described in Item 105 of Regulation S-K. The Revised Alternative Disclosures must be audited only if the parent company elects to provide the disclosures in its audited financial statements.

The SEC believes that providing parent companies the flexibility to select the location of disclosures in its filings is appropriate, and that allowing such disclosures to be included outside the financial statements will reduce costs and promote capital formation.

Duration of Required Disclosures in Relation to Guaranteed Securities. The final amendments will eliminate the existing requirement that the parent company must continue to provide Alternative Disclosures in its periodic reports for as long as the subject securities are outstanding. Instead, the parent company will be allowed to cease providing Revised Alternative Disclosures if the corresponding subsidiary issuer's or guarantor's Section 15(d) obligation is suspended automatically by operation of Section 15(d)(1) or through compliance with Rule 12h-3 of the Exchange Act. In order to omit the financial statements of a subsidiary issuer or guarantor, a parent company must however continue providing the Revised Alternative Disclosures for so long as the subsidiary issuer or guarantor has a Section 12(b) reporting obligation with respect to the guarantee or guaranteed security.

Recently Acquired Subsidiary Issuers and Guarantors. The final amendments will eliminate the existing requirement for a parent company to provide one year of pre-acquisition audited financial statements of recently acquired subsidiary issuers and guarantors under exising Rule 3-10. However, under new Rule 13-01, if the parent company has acquired a significant "business" after the date of its most recent balance sheet date included in its consolidated financial statements and that acquired business and/or one or more of its subsidiaries are obligated as issuers and/or guarantors, then pre-acquisition Summarized Financial Information will need to be provided in a Securities Act registration statement filed in connection with the offer and sale of the guaranteed security. Whether a "business" has been acquired will be determined in accordance with the guidance set forth in Rule 11-01(d) of Regulation S-X. In turn, an acquired business will be deemed "significant" based on the same significance tests and thresholds used to determine whether pre-acquisition financial statements are required for an acquired business pursuant to Rule 3-05 of Regulation S-X.

Amended Rule 3-16 / New Rule 13-02

As with the Rule 3-10 amendments discussed above, the SEC's overarching principle with respect to the 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.

The final amendments:

- replace the existing requirement to provide separate financial statements for each affiliate whose securities are pledged as collateral with a new requirement to provide Revised Alternative Disclosures consisting of

financial and non-financial disclosures about the affiliates and the collateral arrangement as a supplement to the consolidated financial statements of the registrant that issues the collateralized security;

- 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; and
- permit the Revised Alternative Disclosures to be provided outside the notes to the parent company's audited annual and unaudited interim consolidated financial statements in the registration statement for the subject offering and all subsequent periodic SEC filings.

We describe these amendments in more detail below. Most of the amendments to Rule 3-10 relating to subsidiary guarantors and issuers of guaranteed debt securites are similar to the Rule 3-16 amendments as they relate to affiliates the securities of which are pledged and comprise part of the collateral for the registered securities.

Revised Alternative Disclosures. Under the final amendments, Rule 3-16 financial statements will be replaced with a requirement that a registrant provide financial and non-financial disclosures about the affiliates and the collateral arrangement.

Similar to amended Rule 3-10, new Rule 13-02 will require, for each affiliate the securities of which are pledged as collateral, amended financial disclosures in the form of Summarized Financial Information, which will include select balance sheet and income statement line items, as well as an accompanying note that briefly describes the basis of presentation. Summarized Financial Information of each such affiliate consolidated in the registrant's consolidated financial statements may be presented on a combined basis and will cover only the most recently ended fiscal year and year-to-date interim period included in the parent company's financial statements.

New Rule 13-02 will also require non-financial disclosures to the extent material to holders of the collateralized security to be provided, including (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, including events that would require delivery of the collateral, (3) a description of the trading market for the affiliate's security pledged as collateral or a statement that there is no market, and (4) any other quantitative or qualitative information that would be material in making an investment decision with respect to the collateralized security.

New Rule 13-02 will apply to collateralized debt securities issued on or after January 4, 2021, and to each registered security issued and outstanding before January 4, 2021, for which the registrant has previously been required to provide Rule 3-16 Financial Statement.

Replacing the "Substantial Portion" Numerical Threshold with a Materiality Test. Instead of requiring Revised Alternative Disclosures only when pledged securities meet the existing rule's "substantial portion" test, the final amendments will require the Revised Alternative Disclosures in all cases, to the extent material.[7] Further, new Rule 13-02 will require disclosure of any financial and narrative information about the affiliate if the information would be material for investors to evaluate the pledge of the affiliate's securities as collateral. It will also require disclosure of sufficient information so as to make the financial and non-financial information not misleading.

Location and Audit Requirement for Revised Alternative Disclosure vs. Alternative Disclosures. Similar to the disclosures for issuers and guarantors of guaranteed debt securities under the amended Rule 3-10 discussed above, new Rule 13-02 gives registrants the flexibility to provide the Revised Alternative Disclosures inside or outside the registrant's audited annual and unaudited interim financial statements in registration statements covering the offer and sale of the collateralized securities and any related prospectus, as well as in Exchange Act periodic reports required to be filed subsequent to the debt offering. If not otherwise included in the consolidated financial statements or in MD&A, the parent company will be required to include the Revised Alternative Disclosures in its prospectus immediately following "Risk Factors" or otherwise, immediately following pricing information described in Item 105 of Regulation S-K.

Recently Acquired Affiliates whose Securities are Pledged as Collateral. Similar to new Rule 13-01, the new Rule 13-02 will require pre-acquisition Summarized Financial Information for recently-acquired affiliates the securities of which are pledged as collateral to be provided in a Securities Act registration statement filed in connection with the offer and sale of the collateralized security if the registrant has acquired a significant "business" after the date of its most recent balance sheet date included in its consolidated financial statements and that acquired business and/or one or more of its subsidiaries are affiliates the securities of which are pledged as collateral.

Transition to Final Amendments

For Securities Act registration statements, the final amendments will apply to any registration statement that is first filed on or after January 4, 2021. Any post-effective amendment filed on or or after January 4, 2021 must include either the registrant's latest audited financial statements in the registration statement or update the prospectus under Section 10(a)(3).

The final amendments will apply to any Exchange Act registration statement that is first filed on or after January 4, 2021.

With respect to Exchange Act periodic reports: (i) if the reporting company was required to comply with the final amendments in a registration statement, all Exchange Act periodic reports for periods ending after that registration statement became efffective must comply with the final amendments and (ii) for all other Exchange Act reporting companies, the annual report on Form 10-K or Form 20-F, as applicable, for fiscal years ending after January 4, 2021, and quarterly reports on Form 10-Q for quarterly periods ending after January 4, 2021, must comply with the final amendments.

Practical Considerations

In General. The final amendments to Rules 3-10 and 3-16 are a welcome development for issuers contemplating registered debt offerings that include guarantees or pledges of affiliate securities as collateral, and a welcome relief for registrants subject to SEC reporting requirements that have issued registered debt securities involving guaranteed or collateralized securities. In most cases, the new rules would reduce issuer cost and time burdens. From an investor's perspective, the final amendments will require that issuers provide information material to an investment decision about guaranteed and collateralized debt securities and eliminate overly detailed, prescriptive disclosures that many find difficult to understand or that are not material to the investment decision.

Revisiting SEC-Registered Debt Offerings. The amendments will provide debt issuers greater flexibility in pursuing transactions featuring these credit enhancements through an SEC-registered offering, and will likely cause issuers to reconsider or revisit the option of conducting an SEC-registered issuance over the Rule 144A route.

The ability of issuers to conduct debt offerings that feature these credit enhancements on an SEC-registered basis may also lead to better pricing terms.

Guarantees by Controlled Subsidiaries. By replacing the condition that a subsidiary issuer or guarantor be 100%-owned by the parent company with a condition that it be consolidated in the parent company's consolidated financial statements, the amendments will make it easier for controlled subsidiaries and joint venture entities to provide guarantees for debt securities. Making it easier for subsidiary guarantors to provide upstream guarantees to parent company issued debt also enhances the overall credit silo available for debt holders and avoids structural subordination issues.

Greater Flexibility for "Up-C" and "UPREIT" Structures. Allowing controlled subsidiaries that are not wholly-owned by a parent company to provide credit support to the latter in the form of guarantees without the bursensome Rule 3-10 financial statement requirements would also be a welcome development for businesses utilizing umbrella partnership-C corporation or "UP-C" structures or umbrella partnership-real estate investment trust or "UPREIT" structures. An operating partnership that is a consolidated subsidiary may, under these new rules, guarantee SEC-registered debt issued by its parent company, without the operating partnership being required to be a SEC registrant itself or be subject to Exchange Act periodic reporting requirements itself.

Foreign Private Issuers and MJDS Filers. The final amendments will apply to foreign private issuers. In its adopting release, the SEC approved related amendments to Form 20-F, F-1 and F-3. However, when a subsidiary issuer or subsidiary guarantor is eligible to register the offer and sale of its security under the multijurisdictional disclosure system ("MJDS"), the financial statements that would appear in the registration statement and in any annual report on Form 40-F filed by the Canadian parent company would not be affected by the final amendments to Rules 3-10 and 3-16. Instead, according to the SEC, the disclosure would be in accordance with Canadian disclosure standards. When the subsidiary issuer or guarantor is not eligible to register the offer and sale of its security under the MJDS, the requirements of the amended rules will be applicable to financial statements of that subsidiary.

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Endnotes

[1] SEC Release No. 33-10762, *Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities* (March 2, 2020), *available at* www.sec.gov/rules/final/2020/33-10762.pdf.

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

[3] 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.

[4] For instance, in the case of a finance subsidiary issuing securities guaranteed by its parent company, existing Rule 3-10(b)(4) requires, as one of the conditions to omit the financial statements of the finance subsidiary issuer, that the parent company includes in its consolidated financial statements a footnote (i) that "the issuer is a 100%-owned finance subsidiary of the parent company and the parent company has fully and unconditionally guaranteed the securities" and (ii) that includes other narrative disclosures specified in paragraphs (i)(9) and (i)(10) of Rule 3-10. In this case, Consolidating Information is not required.

[5] Under Rule 1-02(bb)(1) of Regulation S-X, summarized financial information means the presentation of summarized information as to the assets, liabilities and results of operations of the entity for which the information is required, and will include disclosures of current assets, noncurrent assets, current liabilities, noncurrent liabilities, redeemable preferred stock, noncontrolling interests, net sales or gross revenues, gross profit, income or loss from continuing operations, net income or loss, and net income or loss attributable to the entity.

[6] To assist in materiality determinations, new Rule 13-01(a)(4)(vi) provides four non-exclusive scenarios which, if applicable and disclosed, allow the parent company to omit the financial disclosures. The four scenarios are:

(A) The assets, liabilities and results of operations of the combined issuers and guarantors of the guaranteed security are not materially different than corresponding amounts presented in the consolidated financial statements of the parent company;

(B) The combined issuers and guarantors, excluding investments in subsidiaries that are not issuers or guarantors, have no material assets, liabilities or results of operations;

(C) The issuer is a finance subsidiary of the parent company, the parent company has fully and unconditionally guaranteed the security, and no other subsidiary of the parent company guarantees the security; and

(D) 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.

Note that scenarios (C) and (D) above in new Rule 13-01(a)(4)(vi) are generally consistent with the existing Rule 3-10(b) narrative disclosures involving finance subsidiaries. See *supra* note 3. Hence, neither Consolidating Information nor Summarized Financial Information will be required for scenarios (C) and (D). Instead, only the non-financial disclosures under Rule 13-01(a) would be applicable.

[7] To assist in materiality determinations, new Rule 13-02(a)(4)(vi) provides two non-exclusive scenarios which, if applicable and disclosed, allow the parent company to omit the financial disclosures. The two scenarios are:

(1) The assets, liabilities and results of operations of the combined affiliates whose securities are pledged as collateral are not materially different than the corresponding amounts presented in the consolidated financial statements of the registrant; and

(2) The combined affiliates whose securities are pledged as collateral have no material assets, liabilities or results of operations.