March 17, 2020

SEC Adopts Simplified Disclosure Requirements for Guaranteed and Secured Notes in Registered Offerings

On March 2, the SEC published final rules (available here) amending and simplifying the financial disclosure requirements of Rule 3-10 of Regulation S-X for issuers and guarantors of registered guaranteed debt securities and of Rule 3-16 of Regulation S-X for affiliates whose securities collateralize registered securities issued by their affiliated issuers.

Rules 3-10 and 3-16 are based on an overarching principle that purchasers of guaranteed debt securities make their investment decisions by relying primarily on the consolidated financial statements of the parent company registrant and supplemental details about the consolidated subsidiary issuers and guarantors. In that context, the goal of the revised rules is to improve the quality of disclosure and encourage registrants to conduct debt offerings on a registered basis by focusing on material information that is relevant to investors and eliminating prescriptive requirements that are unnecessary and burdensome.

The final rules reflect revisions to existing Rule 3-10 and to Rule 3-16 (which remains in place for transitional purposes) and the creation of two new rules, Rule 13-01 (corresponding to Rule 3-10) and 13-02 (corresponding to Rule 3-16). The new rules now comprise new Article 13. The final rules become effective January 4, 2021, but registrants may voluntarily comply with them before the effective date.

Rule 3-10 Amendments and New Rule 13-01

Existing Rule 3-10 requires registrants to file separate annual audited and unaudited interim financial statements for each issuer and guarantor of their registered debt securities, unless one of the five exceptions to this general rule applies. Each of the exceptions imposes specific conditions that must be met before the separate financial statements for each qualifying subsidiary issuer and/or guarantor may be omitted. These historical requirements reflect the SEC position that a guarantee is a separate security for purposes of the Securities Act of 1933 (the "Securities Act") and, therefore, any guarantor should be treated just like an issuer for purposes of financial statement requirements. Unless the conditions for omission of separate financial statements for each subsidiary issuer and guarantor are met, those separate financial statements must be provided in the Securities Act registration statement and subsequent reports required by the Securities Exchange Act of 1934 (the "Exchange Act").

Revised Rule 3-10 will continue to permit registrants to omit separate financial statements of subsidiary issuers and/or guarantors if a prescribed set of eligibility criteria are met and the parent company provides,

to the extent material, the supplemental financial and non-financial disclosure about the subsidiary issuers and/or guarantors and the guarantees.

Revised Rule 3-10 simplifies the existing disclosure requirements and creates a single set of eligibility criteria applicable to all registrants and guarantor structures.

New Rule 13-01 lays out the disclosure requirements for supplemental financial and non-financial information in a single location.

Among the key changes to Rule 3-10 are:

- the replacement of the condition that a subsidiary issuer or guarantor be 100%-owned by the parent company with a condition that the subsidiary issuer or guarantor be consolidated in the parent company's consolidated financial statements;
- the replacement of the requirement for condensed consolidating financial information with a requirement for certain new financial and non-financial disclosures. The required information will be summarized financial information (as defined in Rule 1-02(bb)(1) of Regulation S-X) that may be presented on a combined basis, will not require cash flow statement information and will cover fewer fiscal periods;
- the exclusion of non-issuer and non-guarantor subsidiary information; and
- the reduction in the length of time during which the parent company is required to provide supplemental financial and non-financial information. Under the existing rules, the parent company has a continuing obligation to present the supplemental information for as long as the guaranteed securities are outstanding; however, under the revised rules, the parent company will be able to cease providing such information if the reporting obligations under Section 15(d) of the Exchange Act of the subsidiary issuer or guarantor with respect to the guaranteed securities have been suspended or terminated. This relief will not help where debt securities are listed.

Eligibility criteria for omission of financial information

The parent company will be permitted to omit separate financial statements of a subsidiary issuer or guarantor if it meets the following eligibility conditions:

- the consolidated financial statements of the parent company have been filed;
- the subsidiary issuer or guarantor is a consolidated subsidiary of the parent company – in connection with this requirement, under new Rule 13-01(a), the registrant must provide a description of any factors that may affect payments to holder of the guaranteed debt, such as the rights of a non-controlling

interest holder, and separate disclosure of summarized financial information for the registrants and guarantors to which those factors apply;

- the guaranteed security is "debt or debt-like" – under new guidance provided in Rule 3-10(b)(2), a guaranteed security will be considered "debt or debt-like" if the registrant 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;

- one of the following registrant/guarantor structures is applicable (which replace the five exceptions in existing Rule 3-10(b) - (f)):

  - the parent company either issues the security or it co-issues the security, jointly and severally, with one or more of its consolidated subsidiaries; or

  - a consolidated subsidiary issues the security or it co-issues the security with one or more other consolidated subsidiaries of the parent company, and in either case the security is guaranteed fully and unconditionally by the parent company.

Under revised Rule 3-10, a subsidiary issuer or guarantor will not be required to be designated as a "finance subsidiary" for purposes of determining whether the registrant and guarantor structure is eligible.

Financial and non-financial disclosure requirements

In addition to satisfying the initial eligibility criteria that would allow a parent company to avoid having to submit separate financial statements of subsidiary issuers and/or guarantors, the parent company will be required to provide, to the extent material, certain financial and non-financial disclosures about the subsidiary issuers and guarantors. If the parent company determines that not all of the required financial information is material, the information that is not material may be omitted without additional disclosure or explanation.

Under new Rule 13-01, the following requirements will apply to supplemental financial information required to be provided in relation to subsidiary issuers and guarantors:

- Summarized financial information to the extent material,[1] which should include select balance sheet and income statement line items as well as additional unspecified separate line items of financial

[1] To assist registrants in determining which financial information would not be material and could be omitted, new Rule 13-01(a)(4)(vi) presents four scenarios that represent the most common situations under which financial information would not be material:

- the assets, liabilities and results of operations of the combined issuers and guarantors of the guaranteed security are not materially different from the corresponding amounts presented in the consolidated financial statements of the parent company;

information (*e.g.*, a guarantor's transactions with non-obligated subsidiaries) but only to the extent they are material to an investment decision; no supplemental cash flow statement information about subsidiary issuers and guarantors will be required; registrants are also asked to briefly describe the basis of presentation applicable to each of the required financial disclosures.

- Summarized financial information about each consolidated subsidiary issuer and guarantor can be presented on a combined basis with the summarized financial information of the parent company; intercompany balances and transactions between issuers and guarantors whose summarized financial information is presented on a combined basis do not need to be disclosed.

  Additionally, the new rule requires all non-issuer and non-guarantor subsidiary financial information to be entirely removed from the financial information of the obligor group, even if a subsidiary issuer or a guarantor normally would consolidate such non-issuer and non-guarantor subsidiaries. If the required information is applicable to one or more, but not all, registrants or guarantors, then, to the extent that it is material, separate disclosure of summarized financial information for the registrants and guarantors to which the information applies will be required.

- Summarized financial information is required to be provided as of and for the most recently ended fiscal year and the most recent *year-to-date* interim period included in the parent company's consolidated financial information (which means that even if the parent company provides both year-t0-date and quarter-to-date financial statements, only year-to-date financial information needs to be provided).

The following non-financial disclosures about the subsidiary issuers, guarantors and guarantees will need to be provided under Rule 13-01:

- a description of the registrants and guarantors of the guaranteed security;

- a description of the terms and conditions of the guarantees, and how payments to holders of the guaranteed security may be affected by the composition of and relationships among the registrants, guarantors and non-obligated subsidiaries of the parent company;

  - the combined issuers and guarantors, excluding investments in subsidiaries that are not issuers or guarantors, have no material assets, liabilities or results of operations;
  - 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
  - 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.

  If any one of these scenarios is applicable and disclosed, the parent company could then omit the financial disclosures. The scenarios are not intended to be exclusive; there may be other circumstances in which it would be appropriate to omit financial information on the basis that it is not material.

- a description of other factors that may affect payment to holders of the guaranteed security, such as contractual or statutory restrictions on dividends, guarantee enforceability or the rights of a non-controlling interest holder; and

- where the non-financial disclosure is applicable to one or more, but not all, registrants or guarantors, then, to the extent that it is material, a separate disclosure of summarized financial information for the registrants and guarantors to which the information applies will be required.

In addition to providing the specified financial and non-financial information discussed above, the parent company is also required to disclose:

- any financial and narrative information about each guarantor if the information would be material for investors to evaluate the sufficiency of the guarantee (Rule 13-01(a)(6)); and

- sufficient information as to make the financial and non-financial information presented not misleading (Rule 13-01(a)(7)).

Location of the financial and non-financial disclosures

The parent company has the flexibility to place the supplemental financial and non-financial disclosures in or outside the footnotes to its consolidated financial statements or, alternatively, in the MD&A in all of its filings. If the disclosures are not included in either of these locations, the parent company is to include the disclosure in its prospectus immediately following "Risk Factors," if any, or otherwise immediately following pricing information. Disclosures included in a footnote to the audited consolidated financial statements must be audited; disclosures included in other permitted locations need not be audited.

Continuous reporting obligations

The financial and non-financial disclosures about the subsidiary issuers and guarantors will cease to be required if the corresponding reporting obligation of the subsidiary issuer or guarantor with respect to the guaranteed security has been suspended or terminated under the Exchange Act (*e.g.*, suspension by operation of Section 15(d)(1) or through compliance with Rule 12h-3, or in the case of foreign private issuers, Rule 12h-6). A parent company would, however, continue to be required to provide the relevant financial and non-financial disclosures with respect to securities that are traded on a national securities exchange. If a subsidiary or guarantor with an Exchange Act reporting obligation for guaranteed securities were initially able to omit its financial statements and could rely on Rule 12h-5, but later ceased to satisfy those requirements, the subsidiary would be required to begin filing Exchange Act reports for the period during which it ceased to satisfy the requirements of amended Rule 3-10.

Recently acquired subsidiary issuers and guarantors

With respect to specific disclosures about recently acquired subsidiary issuers and guarantors, pre-acquisition summarized financial information about a subsidiary issuer or guarantor acquired after the balance sheet date of the parent company's most recent financial statements would be required to be disclosed if the acquired entity constitutes a significant "business" and that acquired business and/or one or more of its subsidiaries are obligated as issuers and/or guarantors.

An acquired business will be treated as significant if it meets any of the conditions specified in the definition of a significant subsidiary in Rule 1-02(w) of Regulation S-X, substituting a 20% threshold for the 10% threshold, based on a comparison of the most recent annual financial statements of the acquired business and the parent company's most recent annual consolidated financial statements filed at or prior to the date of acquisition. (Note that these are the same significance tests as those used to determine whether pre-acquisition financial statements are required for an acquired business pursuant to Rule 3-05 of Regulation S-X.)

Foreign private issuers

Foreign private issuers will be required to fully comply with revised Rule 3-10 as well as new Rule 13-01. A foreign private issuer that prepares its financial statements on a basis other than U.S. GAAP or IFRS as issued by the International Accounting Standards Board will not be required to reconcile the supplemental financial disclosures to U.S. GAAP. A new exhibit (No. 17) has been added to Item 19 of Form 20-F that covers identification of each subsidiary that is a guarantor, issuer or co-issuer of each guaranteed security that the parent company issues or guarantees.

Rule 3-16 Amendments and New Rule 13-02

Rule 3-16 currently requires a registrant to provide separate annual and interim financial statements for each affiliate whose securities constitute a "substantial portion" of the collateral for the securities registered or being registered, as if the affiliate were the registrant itself. In practice, affiliates whose securities collateralize a registered security are almost always consolidated subsidiaries of that registrant.

Under the existing rules, the determination as to whether an affiliate's securities constitute a "substantial portion" of the collateral is made by comparing the highest amount among the aggregate principal amount, par value, book value or market value of the affiliate's securities to the principal amount of the securities registered or being registered. If the highest of those values equals or exceeds 20% of the principal amount of the securities registered or being registered for any fiscal year presented by the registrant, separate annual and interim financial statements for the affiliate are required.

Under revised Rule 3-16, the existing requirement to provide separate financial statements of an affiliate is replaced with a new requirement that the registrant provide financial and non-financial information about the affiliate and the collateral arrangement as a supplement to the registrant's consolidated financial statements. Revised Rule 3-16 eliminates the "substantial portion" test and requires the specified financial and non-financial disclosures *in all cases* unless they are *not material* to holders of the collateralized security. It also requires disclosure of any additional information about the collateral arrangement and each affiliate whose security is pledged as collateral that would be material to making an investment decision with respect to the collateralized security.

New Rule 13-02(a)(1)-(7)[2] specifies in more detail the financial and non-financial information required to be provided in relation to affiliates whose securities collateralize securities registered or being registered.

The registrant will have the flexibility to place these financial and non-financial disclosures about affiliates either in a footnote to its consolidated financial statements or, alternatively, in the MD&A. If the disclosures are not included in either of these locations, the registrant is to include them in its prospectus immediately following "Risk Factors," if any, or otherwise immediately following pricing information. Disclosures included in a footnote to the audited consolidated financial statements must be audited; disclosures included in other permitted locations need not be audited.

Foreign private issuers are required to fully comply with the requirements of new Rule 13-02.

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[2] Rule 13-02(a)(1)-(7) requires the disclosure of the following information:

- a description of the securities pledged as collateral and the affiliates whose securities are pledged as collateral;
- a description of the terms and conditions of the collateral arrangement, including the events or circumstances that would require delivery of the collateral;
- a description of the trading market for the affiliate's security pledged as collateral or a statement that there is no market;
- summarized financial information of each affiliate whose securities are pledged as collateral, with an accompanying note that briefly describes the basis of presentation;
- pre-acquisition summarized financial information about a subsidiary issuer or guarantor acquired after the balance sheet date of the parent company's most recent financial statements if the acquired entity constitutes a significant "business" and that acquired business and/or one or more of its subsidiaries are obligated as issuers and/or guarantors;
- any financial and narrative information about each such affiliate if the information would be material for investors to evaluate the pledge of the affiliate's securities as collateral; and
- sufficient information so as to make the financial and non-financial information presented not misleading.

The amendment to Rule 3-16 may affect a number of outstanding registered debt securities that have a so-called "Rule 3-16 Exclusion." The typical Rule 3-16 Exclusion provides that capital stock or other securities of an affiliate will be included in the collateral:

> "...to the extent that such capital stock or other securities can secure the notes without Rule 3-16 of Regulation S-X (or any other law, rule or regulation) requiring separate financial statements of such affiliate to be filed with the SEC (or any other governmental agency)...."

By reason of revised Rule 3-16, many Rule 3-16 Exclusion provisions will no longer operate to exclude capital stock and other securities of affiliates, since Rule 3-16 will no longer require the provision of "separate financial statements." Issuers that are currently relying on the Rule 3-16 Exclusion should consider evaluating whether the additional financial and non-financial disclosures about the affiliate and the collateral arrangements would be necessary because they are "material" to holders of the collateralized security.

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We note that while revised Rule 3-10 provides significant relief from the current guarantor footnote requirement, the Rule 144A market is comfortable with even less information — a few line items of non-guarantor information — and, as such, it is likely that the Rule 144A market will continue to carve out Rule 3-10 information from expected disclosures. At the same time, the revised Rule 3-16 requirements could result in collateral being carved back in under existing debt agreements and could result in additional disclosure requirements.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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