SEC Amends Rules Relating to Financial Disclosure Requirements for Registered Debt

March 12, 2020

SEC Eases the Burden of Financial Reporting for Guaranteed and Secured Debt to Encourage Registered Offerings

The SEC has historically imposed burdensome financial statement requirements on companies that issue debt that is either guaranteed by subsidiaries or secured. Because most high yield debt is guaranteed and/or secured and investors have not found such information useful, virtually all high yield debt offerings in recent years have been conducted on an unregistered basis. Last year, the SEC proposed amendments to modify their financial disclosure requirements to encourage more registered high yield debt offerings. On March 2, 2020, the SEC voted to adopt **amendments** that significantly change the financial disclosure requirements in registered offerings applicable to guarantors and issuers of guaranteed securities, and to affiliates whose own securities constitute a portion of the collateral for the securities offered. The amendments reduce the financial disclosures required and focus on information that is material to investors given the specific facts and circumstances of the offering. The new amendments are helpful in alleviating this burden, but do not fully harmonize the SEC requirements with customary disclosure practice in Rule 144A offerings and will continue to impose some additional requirements on issuers compared to customary Rule 144A offering practice. While the amendments are welcome, it remains to be seen if they will achieve the purpose of significantly increasing the number of registered high yield debt offerings.

SEC's current rules

The SEC's view is that a guarantee of debt is a separate security, and thus a guarantor is also an SEC registrant and must provide full financial statements in an initial registration statement and subsequent filings while that guarantee is outstanding. Rule 3-10 of Regulation S-X provides several exceptions to the general requirement, which are typically available for subsidiaries of a parent company and permits the guarantors to not provide full financial statements or ongoing SEC reports. To qualify for the relief: (i) each subsidiary must be 100% owned by the parent company and (ii) each guarantee must be "full and unconditional." To take advantage of the exception, Rule 3-10 requires the parent company to provide alternative disclosures that usually require fully condensed consolidating financial information concerning the guarantor and non-guarantor subsidiaries in the parent company's audited and interim financial statements. In order to avoid ongoing public reporting by the subsidiary, the parent company must continue to provide the alternative disclosures in its periodic reports for as long as the guaranteed securities are outstanding. In addition, for recently acquired subsidiaries that are "significant," the rule requires the filing of pre-acquisition audited financial statements. The significance test in the rule is stricter than the usual significance test for an acquired company's financial statements, which can make it especially problematic to use a recently acquired subsidiary as a guarantor or issuer in an SEC-registered debt offering.

Rule 3-10's requirements are onerous and, in our experience, issuers avoid them by issuing debt in private offerings where investors and issuers are comfortable with alternative disclosure. The alternative disclosure typically focuses on the amount of revenue and operating income that is included in the guarantor/non-guarantor groups, and the amount of debt and other liabilities in the non-guarantor group.

The SEC also has a separate rule, Rule 3-16 of Regulation S-X, which requires a company to provide separate audited annual and unaudited interim financial statements for each affiliate whose securities constitute a "substantial portion" of the collateral for a security offered in a registered offering. To determine whether the affiliate securities constitute a "substantial portion" of the collateral, the greater of

the principal amount, par value, book value or market value of the affiliate securities is compared to the principal amount of the securities being offered, and if it equals or exceeds 20% of the principal amount of the securities being offered, separate financial statements of the affiliate are required. The financial statement disclosure is not provided in Rule 144A private placements, as issuers and their counsel have historically concluded that this information is simply not material to investors – if the stock being pledged is of a guarantor, then the stock is of no incremental value to creditors, and if the stock is of a non-guarantor, it can be included in a disclosure as to book value of the collateral. Producing the currently required financial statements is costly and includes disclosure on specific entities that can reveal confidential information.

New Rule 13-01 – Guaranteed Securities

The final amendments to these rules were adopted substantially as proposed in July 24, 2018, although a few modifications were made and are noted below. The adopted amendments to Rule 3-10 and new Rule 13-01 will 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 and that certain specific financial and non-financial disclosures (set out below) be included in the prospectus.

Financial Disclosures. The SEC has imposed specific disclosure requirements that go beyond what is typically included in Rule 144A offerings, despite comments from Davis Polk and other firms recommending more flexibility to allow issuers to determine what metrics are most relevant. The following specific list of "summarized financial information" must generally be included for the issuer and guarantors for the most recent year and subsequent interim period:

- Current assets, non-current assets, current liabilities, non-current liabilities, and, when applicable, redeemable preferred stocks and non-controlling interests;
- Net sales or gross revenues, gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues), income or loss from continuing operations, net income or loss, and net income or loss attributable to the entity

Such information can be omitted if not material, which would provide some discretion to issuers to eliminate line items that they view as immaterial. However, the SEC guidance on materiality in the adopting release and the rule suggests that the Commission's view is that elimination of this information on materiality standards should occur only where the information for the guarantor group is substantially the same as for the consolidated group or where the issuer is a finance subsidiary. In addition to the required information, issuers must include such other financial information they deem material for investors.

Importantly, the SEC modified the initial proposal to state that financial information need not be audited or included in the financial statements. This is consistent with Rule 144A offering practice and is helpful, as the cost of additional audit work is a significant disincentive to registered offerings.

The SEC also eliminated the requirement to provide pre-acquisition financial statements of recently acquired subsidiary companies and guarantors, but will require pre-acquisition summarized financial information about recently acquired subsidiary guarantors when the recently acquired guarantors are part of a business that is "significant" (as defined pursuant to Regulation S-X) and otherwise requires financial statements under the SEC's rules.

Non-Financial Disclosures: The SEC imposed a number of disclosure requirements about the guarantors and the terms of the guarantees, including any contractual or statutory restrictions on dividends or guarantee enforceability. These disclosures are consistent with the type of disclosures that would typically be included in Rule 144A offerings.

The new rule requires the amended financial and non-financial disclosures to be included in Exchange Act reports for as long as the companies and guarantors have an Exchange Act reporting obligation with

respect to the guaranteed securities, an obligation that usually lapses in the company's next fiscal year following the issuance (unless the debt securities are listed), rather than for as long as the guaranteed securities are outstanding, as currently required.

Amendment to Rule 3-16 and New Rule 13-02

The SEC based the amendments to Rule 3-16 on the principle that the most relevant information for an investment decision regarding a company's securities is the company's own consolidated financial statements. The SEC noted that "[t]he pledge of collateral is a residual equity interest that could potentially be foreclosed upon only in the event of default and almost always relates to an affiliate whose financial information is already included in the company's consolidated financial statements." As a result, the SEC concluded that separate financial statements of each affiliate whose securities are pledged as collateral are not material in most situations. Accordingly, Rule 3-16 was amended and new Rule 13-02 adopted to:

- Replace the requirement to provide disclosure based on the 20% "substantial portion" test with a requirement to provide financial and non-financial disclosures to the extent material. Disclosure would also be required of any financial and narrative information about each affiliate if the information would be material for investors to evaluate the pledge of the affiliate's securities as collateral.
- If materiality is established, replace the existing requirement to provide separate financial statements for an affiliate whose securities are pledged as collateral with a requirement to provide specific financial and non-financial disclosures, including summarized financial information about the affiliate and the collateral arrangement as a supplement to the consolidated financial statements of the registrant that issues the collateralized security. When separate financial information applicable to the affected affiliates can be easily explained and understood, the rule permits narrative disclosure instead of the separate summarized financial information of the affected affiliates. Consistent with the approach in respect of Rule 3-10, financial information would be required about newly acquired entities whose securities are pledged if they were acquired as part of a "significant" (as defined pursuant to Regulation S-X) acquisition that otherwise requires reporting under SEC rules.
- Require the financial disclosures to be provided as of and for the most recently ended fiscal year and most recent year-to-date interim period included in the registrant's consolidated financial statements.
- Require certain non-financial disclosures about the securities pledged as collateral, such as the terms and conditions of the collateral arrangement, and whether a trading market exists for the pledged securities, along with disclosure about additional facts and circumstances specific to particular affiliates that would be material to holders of the collateralized security.
- Permit the disclosures to be located outside the company's financial statements.

We believe that in most cases, issuers will conclude that financial information is not material and be able to omit such information. The non-financial disclosures are typically consistent with those provided in Rule 144A offerings.

Effective Date and Transition

The final amendments are effective on January 4, 2021 and will also apply to foreign private issuers, smaller reporting companies and to offerings pursuant to Regulation A of the Securities Act of 1933, as amended (the "Securities Act"). Voluntary compliance with the final amendments, rather than the SEC rules in effect prior to these amendments, is permitted in advance of the effective date.

The final amendments will mandatorily apply to:

- any Securities Act registration statement that is first filed on or after January 4, 2021, and any post-effective amendment filed on or after January 4, 2021, to include either the registrant's latest audited financial statements in the registration statement or to update the prospectus under Section 10(a)(3);
- any Exchange Act registration statement that is first filed on or after January 4, 2021;
- any Exchange Act periodic reports if the reporting company was required to comply with the final amendments in a registration statement, for periods ending after that registration statement became effective; and
- 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.

Importantly, Rule 3-16 as currently in effect will apply to any security issued before January 4, 2021. For such a security, this means that if a stock pledge would be required under the indenture but for a provision that excludes collateral when inclusion would require disclosure under Rule 3-16, the old rule continues to apply and no stock pledge is required. This is a helpful feature of the final rule that should avoid disrupting an issuer's expectations.

Generally, we expect that issuers who want to pursue registered offerings of guaranteed debt will voluntarily comply with the new rules and provide the more limited disclosures.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

Maurice Blanco		212 450 4086	maurice.blanco@davispolk.com
Alan F. Denenberg		650 752 2004	alan.denenberg@davispolk.com
Joseph A. Hall		212 450 4565	joseph.hall@davispolk.com
Michael Kaplan		212 450 4111	michael.kaplan@davispolk.com
James C. Lin	+	852 2533 3368	james.lin@davispolk.com
Byron. B. Rooney		212 450 4658	byron.rooney@davispolk.com
Sarah Solum		650 750 2011	sarah.solum@davispolk.com
Richard D. Truesdell, Jr.		212 450 4674	richard.truesdell@davispolk.com
Edith Fassberg		212 450 3883	edith.fassberg@davispolk.com