

Client Alert

March 2020

SEC Adopts Rules to Simplify and Streamline Disclosures in Certain Registered Debt Offerings

On March 2, 2020, the Securities and Exchange Commission (SEC) adopted rule amendments intended to simplify and streamline the financial disclosure requirements made in connection with registered debt offerings and subsequent periodic reporting for guarantors and issuers of guaranteed securities, as well as for affiliates whose securities collateralize a registrant's securities. The adopted amendments update the financial disclosure requirements in:

- Rule 3-10 of Regulation S-X (Rule 3-10) with respect to guarantors and issuers of guaranteed securities registered or being registered; and
- Rule 3-16 of Regulation S-X (Rule 3-16) with respect to affiliates whose securities are pledged as collateral for securities registered or being registered.

The amendments are intended to make investor disclosures easier to understand, and the SEC is hopeful that the changes will have the effect of increasing the number of public offerings that make use of these kinds of credit enhancements, "thereby affording investors protection they may not be provided in offerings conducted on an unregistered basis." The amendments update and partly relocate Rule 3-10 to new Rule 13-01, and replace the requirements in Rule 3-16 with the requirements in new Rule 13-02.

Rule 3-10: Subsidiary Issuers and Subsidiary Guarantors of Registered Securities

Current Requirements under Rule 3-10

Rule 3-10 requires that financial statements be filed for all issuers and guarantors of registered securities and includes five exceptions from this requirement for subsidiary issuers of debt securities guaranteed by the parent and subsidiary guarantors of debt securities issued by the parent. Separate financial statements are not required for subsidiary issuers and subsidiary guarantors if any one of the five exceptions applies, which, in each case, require that the parent company provide certain disclosures, such as qualifying subsidiary is 100 percent owned by the parent company (that is, all of its outstanding voting shares are owned, either directly or indirectly, by its parent company) and each guarantee is full and unconditional. Pursuant to Rule 3-10, separate financial statements are not required when, subject to certain enumerated conditions:

1. a finance subsidiary¹ issues securities that its parent company guarantees;
2. an operating subsidiary² issues securities that its parent company guarantees;

¹ Rule 3-10(h)(7) states that a subsidiary is a finance subsidiary if it has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company.

² If a subsidiary is not a finance subsidiary, it is an operating subsidiary.

3. a subsidiary issues securities that its parent company and one or more other subsidiaries of its parent company guarantee;
4. a parent company issues securities that one of its subsidiaries guarantees; or
5. a parent company issues securities that more than one of its subsidiaries guarantees.

Once an exception applies to a subsidiary issuer or subsidiary guarantor, Rule 3-10 allows for alternative disclosures related to such subsidiary ranging from a brief narrative disclosure to a detailed condensed consolidating financial footnote to the parent’s financial statements. In addition, once a subsidiary is exempt from filing independent financial statements pursuant to Rule 3-10, such subsidiary is also exempt from the periodic reporting requirements of the Securities Exchange Act of 1934, as amended (Exchange Act).

Adopted Amendments to Rule 3-10

The adopted amendments to Rule 3-10 expand the eligibility requirements for the exceptions to the requirement to provide subsidiary financial statements and permit registrants to omit, in certain circumstances, separate financial statements of the subject subsidiary issuers and guarantors. This change should generally eliminate the current need for registrants to request no-action relief from the SEC when a subsidiary co-issues debt securities with its parent. As shown in the table below, the amendments to Rule 3-10 generally do not reduce the types of entities or transaction structures able to rely on exceptions from the financial statement requirement.

Eligibility Requirements	Current Rule 3-10	Adopted Rule 13-01
All Must Be True	Parent company has filed its consolidated financial statements;	Parent company has filed its consolidated financial statements;
	The parent owns, directly or indirectly, 100 percent of the subsidiary issuer or subsidiary guarantor;	The subsidiary issuer or subsidiary guarantor is a subsidiary consolidated with the parent company for GAAP purposes;
	The guaranteed security is a debt security; and	The guaranteed security is a debt or debt-like security; ³ and
	Any co-obligation is not limited or conditional and any guarantee is full and unconditional.	The guarantee is full and unconditional.
One Must Be True	A finance subsidiary issues securities that its parent company guarantees;	The parent company issues the security or co-issues the security, jointly and severally, with one or more of its consolidated subsidiaries; or
	An operating subsidiary issues securities that its parent company guarantees;	
	A subsidiary issues securities that its parent company and one or more other subsidiaries of its parent company guarantee;	
	A parent company issues securities that one of its subsidiaries guarantees; or	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

³ Existing Rule 3-10 does not define when a security is “debt or debt-like.” Amended Rule 3-10(a)(1) provides that the guaranteed security must be “debt or debt-like” and amended Rule 3-10(b)(2) provides that a guaranteed security will be considered “debt or debt-like” if: (a) the issuer has a contractual obligation to pay a fixed sum at a fixed time; and (b) where the obligation to make such payments is cumulative, a set amount of interest must be paid.

Eligibility Requirements	Current Rule 3-10	Adopted Rule 13-01
	A parent company issues securities that more than one of its subsidiaries guarantees.	is guaranteed fully and unconditionally by the parent company.

Under the adopted amendments to Rule 3-10, the alternative disclosures allowed once a subsidiary is exempt from filing separate financial statements are reduced with respect to financial information and expanded with respect to qualitative narrative disclosures. The adopted amendment to Rule 3-10 only requires “summarized financial information” as defined in Regulation S-X, which is limited to summarized information as to such subsidiary’s assets, liabilities and results of operations (Summarized Financial Information).⁴ In addition, the new rule focuses the presentation on the parent company issuer or guarantor, each consolidated subsidiary issuer, and each consolidated subsidiary guarantor (Obligor Group), on a combined basis rather than in separate columns for the parent, subsidiary issuers, subsidiary guarantors and any other subsidiaries. The adopted rule no longer requires separate disclosure of the financial information of nonguarantor subsidiaries.

The adopted rules for nonfinancial disclosures expand the current requirement to include specific nonfinancial disclosures. Additionally, when a nonfinancial disclosure is applicable to one or more, but not all, issuers and guarantors, the adopted rule requires, to the extent it is material, separate disclosure of the financial information for the issuers and guarantors to which it applies.

Disclosure Requirements	Current Rule 3-10	Adopted Rule 13-01
Financial Disclosures	Must include all the major captions of the balance sheet, income statement and cash flow statement;	Must include Summarized Financial Information, with additional line items required under certain circumstances to the extent material to an investment decision; ⁵
	Must provide a separate column for the parent, subsidiary issuers, subsidiary guarantors and all other subsidiaries, each on a combined basis; and	Must provide a column for the Obligor Group on a combined basis, unless any information is applicable to one or more, but not all issuers and guarantors; and
	Must present financial information for the same periods as the parent’s consolidated financial statements.	Must present financial information for the most recently completed fiscal year and year-to-date interim period.
Nonfinancial Disclosures	Requires limited nonfinancial disclosures about the issuers and guarantors and the guarantees, restricted net assets and certain types of	Requires, to the extent material, disclosures about the issuers and guarantors, the terms and conditions of the guarantees, and how the issuer and

⁴ “Summarized Financial Information” is defined in Rule 1-02(bb)(1) of Regulation S-X and includes the following line items: current assets, noncurrent assets, current liabilities, noncurrent liabilities, redeemable preferred stocks (when applicable), noncontrolling interests (when applicable), 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 before extraordinary items and cumulative effect of a change in accounting principle, net income or loss, and net income or loss attributable to the entity.

⁵ Disclosure of additional line items of financial information beyond what is specified in new Rule 13-01(a)(4) will be required if necessary to comply with new Rules 13-01(a)(6) and (7). Additionally, new Rule 13-01(a)(4)(iii) requires an issuer’s or guarantor’s amounts from, amounts due to, and transactions with nonobligated subsidiaries and related parties to be presented in separate line items. A parent company will be permitted to omit the required financial information if one of the four nonexclusive scenarios in new Rule 13-01(a)(4)(vi) is applicable and disclosed.

Disclosure Requirements	Current Rule 3-10	Adopted Rule 13-01
	restrictions on the ability of the parent company or any guarantor to obtain funds from their subsidiaries; and	guarantor structure and other factors may affect payments to holders of the guaranteed securities; and
	Additional facts and circumstances specific to particular issuers and guarantors that would be material to holders of the guaranteed security.	Additional facts and circumstances specific to particular issuers and guarantors that would be material to holders of the guaranteed security. ⁶

In addition to changing the substance of the disclosures, the adopted rules allow registrants the flexibility to provide the alternative financial and nonfinancial disclosures inside or outside of the consolidated financial statements in registration statements covering the offer and sale of the guaranteed debt securities and any related prospectus, as well as annual and quarterly Exchange Act periodic reports required to be filed during the fiscal year in which the first bona fide sale of the subject securities is completed.

Finally, the adopted amendments to Rule 3-10 harmonize the treatment of the duration of the reporting requirements, which currently require a parent to include disclosures regarding its subsidiary issuers and subsidiary guarantors even after such subsidiary's requirement with respect to a particular security has ceased. Under the adopted rule, the parent company will be able to cease providing the disclosures for a subsidiary issuer or subsidiary guarantor that is not required to file financial statements required by Regulation S-X with respect to the guarantee or guaranteed security.

In our experience, registrants who have not previously issued guaranteed debt securities are reluctant to prepare additional separate financial statements due to cost and timing constraints and elect instead to issue debt securities privately to qualified institutional buyers in accordance with Rule 144A of the Securities Act of 1933, as amended, (and without registration rights) in order to omit the additional financial disclosure information required under the current Rule 3-10. The adopted changes may reduce the reliance of such registrants on the 144A for life market. In addition, by removing the "100 percent owned" requirement under the exceptions to the financial statement requirements of Adopted Rule 13-01, noncorporate subsidiary issuers and guarantors in an "Up-C" or similar organizational structure in which the subsidiary is consolidated in the issuer's financial statements but not wholly owned may be more willing to utilize registered debt markets.⁷

Rule 3-16: Affiliates Whose Securities Collateralize Registered Securities

Current Requirements under Rule 3-16

Rule 3-16 requires a registrant to provide separate annual and interim financial statements for each affiliate whose securities constitute a "substantial portion" of the collateral for any class of securities registered or being registered as if the affiliate were a separate registrant. Although affiliates whose securities are pledged as collateral are not registrants with respect to the collateralized security, and are not generally subject to the related reporting requirements, Rule 3-16 requires financial statements as if the affiliate(s) were registrants. In our experience, registrants have structured transactions specifically to avoid the application of Rule 3-16, by either avoiding certain pledges of subsidiary equity that would have otherwise

⁶ In new Exhibit 22 (Item 601(b)(22) of Regulation S-K), the parent company must list each of its subsidiaries that is a guarantor, issuer or co-issuer of guaranteed securities registered or being registered that the parent company issues, co-issues or guarantees.

⁷ Under Rule 3-10(h) of Regulation S-X, application of the "100 percent owned" test is different for noncorporate subsidiaries than corporate subsidiaries by requiring the parent to own all interests of the noncorporate subsidiary, instead of just all of its voting interests, which has in certain situations precluded a parent company in an "Up-C" structure from taking advantage of the exceptions permitted under Rule 3-10 as the parent company does not own all of the membership interests in the noncorporate operating company, notwithstanding its ownership of all of the voting interests in such operating company.

been available to investors or undertaking nonregistered deals where such additional financial statements are not required.

Whether an affiliate’s portion of the collateral is a “substantial portion” is determined 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. Separate annual and interim financial statements are required if the highest of those values equals or exceeds 20 percent of the principal amount of the securities registered or being registered for any fiscal year presented by the registrant. This test results in financial statements being required if a registrant issues a small amount of debt securities, even though an affiliate may be only a small percentage of the registrant’s assets and operations. Conversely, the test also results in there being no requirement to file separate financial statements if a registrant issues a substantial amount of debt securities, even though an affiliate constitutes a large percentage of a registrant’s assets and operations.

Adopted Amendments to Rule 3-16

Noting the onerous nature of the current requirements under Rule 3-16, the SEC’s adopted rules substantially decrease the reporting requirements for affiliates whose securities collateralize registered securities. Rather than provide separate financial statements for each such affiliate, the adopted rule requires that a registrant provide the Summary Financial Information and certain nonfinancial disclosures about the affiliate and the collateral arrangement as a supplement to the registrant’s consolidated financial statements. The Summary Financial Information may also be presented on a combined basis for all consolidated affiliates whose securities are pledged, which was not allowed under the existing rule. Additionally, under the adopted amendments to Rule 3-16, when a nonfinancial disclosure is applicable to one or more, but not all, affiliates, separate disclosure of Summarized Financial Information for the affiliates to which it is applicable is required, to the extent material.

Further simplifying the requirements, instead of requiring disclosure only when the pledged securities meet or exceed a numerical threshold relative to the securities registered or being registered under the current rule’s “substantial portion” test, the adopted amendments to Rule 3-16 require disclosure unless they are immaterial to holders of the collateralized security. Additionally, the adopted amendments to Rule 3-16 require disclosure of any additional information about the collateral arrangement and each affiliate whose security is pledged as collateral that would be material to holders of the collateralized securities. If separate financial statements are omitted under the adopted rule, the registrant must include a statement that those financial disclosures have been omitted and the reasons why the disclosures are not material.

Requirements	Current Rule 3-16	Adopted Rule 13-02
Application	Applies to each affiliate whose securities constitute a “substantial portion” of the collateral for any class of securities registered or being registered.	Applies to each affiliate whose securities collateralize any class of securities registered or being registered unless such disclosure is immaterial.
	Considered a “substantial portion” if the highest of the aggregate principal amount, par value, book value or market value of the affiliate’s securities equals or exceeds 20 percent of the principal amount of the securities registered or being registered for any fiscal year presented by the registrant.	Examples of immateriality include: (i) when the consolidated financial information for the affiliates is not materially different from the registrant’s consolidated financial statements; and (ii) if the securities of an affiliate pledged as collateral do not represent a material amount of collateral to an investor.
Financial Disclosures	Requires separate financial statements of each affiliate whose securities constitute a substantial portion of the collateral; and	Requires Summarized Financial Information for each affiliate, with additional line items required under certain circumstances to the extent material to an investment decision; and
	No presentation on a combined basis	Summarized Financial Information may

Requirements	Current Rule 3-16	Adopted Rule 13-02
	allowed.	be presented on a combined basis for the group of consolidated affiliates whose securities are pledged.
Nonfinancial Disclosures	None.	Requires certain nonfinancial disclosures, to the extent material, about the securities pledged as collateral, each affiliate whose securities are pledged, the terms and conditions of the collateral arrangement and whether a trading market exists for the pledged securities.

Similar to the adopted changes for Rule 3-10, the adopted amendments to Rule 3-16 allow registrants the flexibility to provide the alternative financial and nonfinancial disclosures inside or outside of the consolidated financial statements in registration statements covering the offer and sale of the guaranteed debt securities and any related prospectus, as well as annual and quarterly Exchange Act periodic reports required to be filed during the fiscal year in which the first bona fide sale of the subject securities is completed.

While issuers still need to give careful consideration to certain requirements under the Trust Indenture Act of 1939, as amended, which are applicable to registered debt offerings, the adopted changes to the Rules discussed herein may provide a more compelling case for issuers and investors to consider a registered debt offering or a nonregistered offering with registration rights.

The amendments are effective on January 4, 2021, but the SEC will permit voluntary compliance in advance of the effective date.

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