SULLIVAN & CROMWELL LLP

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Registered Offerings of Debt Securities

SEC Proposes Amendments to Simplify and Streamline Financial Disclosures About Issuers and Guarantors of Guaranteed Securities and Affiliates Whose Securities Collateralize Registered Securities

SUMMARY

On July 24, 2018, the SEC proposed amendments to Rules 3-10 and 3-16 of Regulation S-X, which address financial disclosure requirements for guarantors, issuers of guaranteed securities and affiliates whose securities collateralize a registrant's securities. The proposed rules are intended to focus the disclosures in registered offerings of guaranteed and collateralized debt securities on information that is material to investors, make the disclosures easier to understand, reduce compliance costs and encourage issuers to offer guaranteed or collateralized debt securities on a registered basis.

The proposed rules would also permit parent companies that have subsidiary issuers or guarantors to cease providing additional financial information for those entities once the subsidiary issuer's or guarantor's obligations to file periodic reports under Section 15(d) of the Exchange Act are suspended.

The proposed amendments are available on the SEC's website at https://www.sec.gov/rules/proposed/2018/33-10526.pdf. Public comments on the proposed amendments will be due within 60 days after publication of the proposed amendments in the Federal Register.

BACKGROUND

In September 2015, the SEC issued a *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant* (the "Request"), which, among other things, solicited feedback on the financial disclosure requirements in Regulation S-X, including those in Rules 3-10 and 3-16. Based largely on the comments received following the Request, the SEC's proposed

amendments would revise 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.

A. AMENDMENTS TO RULE 3-10 OF REGULATION S-X

1. Current Framework in Rule 3-10

A guarantee of debt or debt-like security is a separate security under the Securities Act of 1933 (the "Securities Act") and its offer or sale must be registered or exempt from registration under the Securities Act. Rule 3-10 states the general principle that each issuer and guarantor of debt securities in a registered offering must file the financial statements required for a registrant by Regulation S-X. Where issuers and guarantors are part of the same corporate family, though, exceptions to this general rule allow qualifying registrants to omit separate financial statements of their subsidiary issuers and guarantors. There are five exceptions to the general rule based upon the structure of the relationship between the issuer and the guarantor. All five exceptions require that (1) each subsidiary issuer and guarantor be 100% owned by the parent company; (2) each guarantee be "full and unconditional"; and (3) the parent company provide certain disclosures in its consolidated financial statements (the "Alternative Disclosures").

The scope of the Alternative Disclosures depends on the specific exemption available to the issuer, and ranges from a brief narrative description of the relationship of the issuer and guarantor to more complete condensed consolidated financial information (requiring separate columnar information about the parent company, subsidiary issuers or guarantors, and any other subsidiaries of the parent company on a consolidated basis, consolidating adjustments and the total consolidated amounts). In the consolidating footnote, all major captions of the balance sheet, income statement and cash flow statement must be presented.

Given the complexity of many companies' corporate structures, and the ways in which registrants maintain financial records, preparing the required financial statement footnotes can be time consuming and therefore delay a registrant's ability to access the capital markets to offer guaranteed debt securities on a registered basis. Further, because the Alternative Disclosures required by Rule 3-10 must be included in the notes to the parent company's consolidated financial statements, the Alternative Disclosures must therefore be audited for the same periods for which audited financial statements of the parent company are required. As a result, many companies that issue guaranteed securities pursue unregistered offerings.

Issuers and guarantors availing themselves of an exception that allows for the Alternative Disclosures in lieu of separate financial statements in registered offerings are exempt from the periodic reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), by Exchange Act Rule 12h-5. The parent company, however, must continue to provide the Alternative Disclosures for as long as the guaranteed securities are outstanding. This obligation continues even if the subsidiary issuer could have

suspended its reporting obligations had it chosen not to avail itself of the Rule 3-10 exception and reported separately from the parent company.

2. Proposed Rules 3-10 and 13-01

Similar to the existing rule, the proposed amendments to Rule 3-10 would continue to allow eligible subsidiary issuers and guarantors to omit separate financial statements if they meet certain conditions and the parent company provides additional disclosures about the subsidiary issuers, guarantors and guarantees (the "Proposed Alternative Disclosures") as set forth in proposed Rule 13-01. Specifically, the proposed amendments would:

- require that subsidiary issuers or guarantors be consolidated in the parent company's consolidated financial statements rather than be 100% owned by the parent company;
- replace the Alternative Disclosures with the Proposed Alternative Disclosures, which contain summarized financial information for the issuers and guarantors that may be presented on a combined basis and for only as of, and for, the most recently completed fiscal year and year-to-date interim period;
- require specific non-financial disclosures, such as information about the subsidiary issuers and guarantors, the terms and conditions of the guarantees and other material factors that may affect payments to the holders of the guaranteed securities;
- give eligible registrants the option to provide the Proposed Alternative Disclosures either in the footnotes to the parent company's consolidated financial statements as required by the existing rule, or, alternatively, outside of the financial statements in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of the registration statement covering the offer and sale of the guaranteed securities and any related prospectus, as well as in certain Exchange Act reports that are filed during the fiscal year in which the first bona fide sale of the subject securities is completed, thereby reducing the potential for delay in offerings that exists due to the need to prepare audited Alternative Disclosures (although in subsequent annual reports on Form 10-K, the Proposed Alternative Disclosures would need to be included in the financial statements and therefore audited);
- focus only on the parent company's role as issuer, co-issuer or guarantor with respect to the guaranteed security in order to determine whether a particular issuer and guarantor structure falls under the exceptions to the rule;
- eliminate the requirement that recently acquired subsidiary issuers and guarantors provide pre-acquisition audited financial statements; and
- replace the requirement that the Alternative Disclosures be provided for as long as the guaranteed securities are outstanding with the requirement that the Proposed Alternative Disclosures be provided for as long as the subsidiary issuers and guarantors have a reporting obligation under the Exchange Act (which may reduce substantially the period of time following the registered offering for which such disclosures will be required).

3. Request for Comment

The SEC has also requested comment on these proposed amendments to Rule 3-10 to determine, among other things, whether these changes would result in an increase in the number of guaranteed debt offerings that are registered, what factors issuers consider when deciding whether to engage in a registered or private debt offering, how investors are likely to use the Alternative Disclosures under

existing Rule 3-10, and whether the proposed changes to Rule 3-10 would make compliance less burdensome and thereby encourage issuers to structure debt offerings to include guarantees.

B. AMENDMENTS TO RULE 3-16 OF REGULATION S-X

Rule 3-16 requires registrants to provide financial statements for each affiliate whose securities constitute a substantial portion of the collateral for any class of registered securities. The determination of whether an affiliate's portion of the collateral is a substantial portion is based on a numerical threshold, under which the portion is deemed to be substantial if the greatest among the principal amount, par value, book value or market value of the affiliate's securities equals or exceeds 20% of the principal amount of the registered securities.

Noting that a company's consolidated financial statements are the most relevant information for investors making decisions regarding securities that are collateralized by the company's affiliates, the SEC concluded that separate financial statements of the affiliates are not material information in most of these situations. Driven by this notion, the SEC proposed amendments to Rule 3-16, which would be relocated to new Rule 13-02, that, among other things, would:

- require registrants to provide financial and non-financial disclosures about the affiliate and the collateral arrangement as a supplement to the registrant's consolidated financial statements rather than requiring separate financial statements for each affiliate whose securities are pledged as collateral;
- give eligible registrants the option to provide the proposed disclosures in their audited financial statements, or, alternatively, in the registration statement covering the offer and sale of the collateralized securities and any related prospectus, as well as in certain Exchange Act reports that are filed shortly thereafter; and
- require registrants to provide the proposed disclosures in all cases unless they are immaterial to the holders of the collateralized security rather than requiring disclosure only when the pledged securities of the affiliate meet or exceed the 20% threshold of the substantial portion test.[1]

IMPLICATIONS

If adopted, the proposed amendments to the financial disclosure requirements should facilitate SEC registered offerings of guaranteed and collateralized debt securities by reducing the compliance burden on issuers while providing information about subsidiary issuers and guarantors and the terms and conditions of the guarantees. The proposed change to ongoing reporting requirements—eliminating a parent company's obligation to provide the required financial disclosures once the subsidiary issuer's or

[1] The SEC has also requested comment on these proposed amendments to Rule 3-16 to determine, among other things, whether these changes would result in an increase in the number of registered debt offerings that include pledges of affiliate securities as collateral, what factors issuers consider when deciding whether to engage in a registered or private debt offering, how investors use the Rule 3-16 financial statements and how these investors would use the proposed disclosures specified in proposed Rule 13-02, and whether the proposed changes to Rule 3-16 would make compliance less burdensome and thereby encourage issuers to structure debt offerings to include pledges of affiliate securities as collateral.

guarantor's obligations to file periodic reports under Section 15(d) of the Exchange Act are suspended—may ultimately be even more useful, although issuers may wish to consider continuing to include such disclosures, either to facilitate future offerings or if investors show an interest in retaining them.

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