SEC Proposes Amendments to Financial Disclosure Requirements under Regulation S-X

I. Background

The Securities and Exchange Commission ("SEC") recently proposed amendments (the "Proposed Amendments") to Rule 3-10 and Rule 3-16 of Regulation S-X relating to the financial disclosure requirements of guarantors and issuers of guaranteed securities registered or being registered, and issuers' affiliates whose securities collateralize securities registered or being registered. The SEC has already fielded many comments on these financial disclosure requirements and took those comments into consideration when drafting the Proposed Amendments. The overarching principle underlying the amendments is that investors rely primarily on the consolidated financial statements of the issuer, supplemented by additional disclosure by subsidiaries and guarantors. The Proposed Amendments are intended to reduce costs and burdens of compliance, while streamlining and simplifying the disclosure process. By encouraging more registered debt offerings, which would be subject to disclosure liability under Section 11 of the Securities Act of 1933 and facilitate the delivery of collateral and guarantees, the SEC believes the revised rules will afford investors more protection than currently provided by unregistered debt offerings.

II. Current Disclosure Requirements

A. Rule 3-10

Rule 3-10(a) requires that every issuer of a registered security that is guaranteed and every guarantor of a registered security must file the financial statements required for a registrant under Regulation S-X. Rules 3-10(b) – (f) set forth five exceptions to this requirement, applicable when: (1) a finance subsidiary issues securities that only its parent company guarantees; (2) an operating subsidiary issues securities that only its parent company guarantees; (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. If one of the five exceptions is applicable to any particular offering, then separate financial statements of each qualifying subsidiary issuer and guarantor may be omitted. There are two conditions that must be satisfied in order for any of the exceptions in Rules 3-10(b) – (f) to apply: (1) each subsidiary issuer and guarantor must be "100% owned"[1] by the parent company and (2) each guarantee must be "full and unconditional."[2] If these conditions are met, the disclosures required by the specific exceptions range from a brief narrative to a highly-detailed condensed consolidated financial presentation ("Consolidating Information") that is audited for the same periods as the parent's audited financial statements. If the conditions are not met, or none of the five exceptions applies, full financial statements of each issuer and guarantor are required.

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[1] Rule 3-10(h)(1) defines (1) a subsidiary in corporate form as "100% owned" if all of its outstanding voting shares are owned, either directly or indirectly, by its parent company and (2) a subsidiary not in corporate form as "100% owned" if the sum of all interests are owned, either directly or indirectly, by its parent company, except that the sum of all interests owned does not include: (i) securities that are guaranteed by its parent and, if applicable, other 100%-owned subsidiaries of its parent and (ii) securities that guarantee securities issued by its parent and, if applicable, other 100%-owned subsidiaries of its parent.

[2] Rule 3-10(h)(2) defines a guarantee as "full and unconditional" if, when an issuer of a guaranteed security has failed to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if the guarantor does not, any holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable.

Notably, in all cases where Rule 3-10 applies, the parent company must continuously provide the required disclosures for as long as the guaranteed securities are outstanding.

Rule 3-10(g) sets forth the parent company's financial statement requirements for its recently acquired subsidiaries. The parent company must include in the registration statement one year of audited and, if applicable, unaudited interim pre-acquisition financial statements for recently-acquired subsidiary issuers and guarantors that are significant[3] and have not been reflected in the parent company's audited results for at least nine months of the most recent fiscal year.

B. Rule 3-16

Rule 3-16 addresses the financial statement requirements for affiliates[4] whose securities are pledged as collateral for securities registered or being registered. This rule currently requires that a registrant 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. Whether an affiliate's portion of the collateral constitutes 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. If an affiliate's portion of the collateral equals or exceeds 20%, then the financial statement requirements under Rule 3-16 must be complied with.

III. Summary of Proposed Rules

A. Rule 3-10

The proposed amendments eliminate the five exceptions and the two threshold questions in the current rules, adopting a simplified approach that is less prescriptive and relies heavily on determinations of materiality. The requirement that all guarantees must be full and unconditional is replaced with the requirement that either the parent is the issuer or, if the issuer is a subsidiary, then only the parent must provide a full and unconditional guarantee. Essentially, the only requirement to avoid separate financials for each subsidiary is that the subsidiary financial information must be reflected in the consolidated financial statements of the parent. If that threshold condition is met, then the registrant need only disclose certain terms and limitations of the guarantees and summarized financial information for the combined obligor group, if material, thus eliminating the requirement to provide financial information for each separate entity and for the non-obligor group, and allowing the issuer to determine if separate summarized financial information is not material and therefore not required. If the issuer determines the summarized financial information is not material to investors, it is required to explain that determination in a narrative disclosure. The SEC likens this to the specific exceptions where only narrative disclosure is required under the current rules, but also suggests other situations where using a materiality test only narrative disclosure would be required, depending on the specific circumstances.

[3] Under Rule 3-10(g)(1)(ii), a subsidiary is considered significant if its net book value or purchase price, whichever is greater, is 20% or more of the principal amount of the securities being registered.

[4] Rule 1-02(b) of Regulation S-X defines an "affiliate of, or a person affiliated with a specific person" as "a person that that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." Affiliates whose securities collateralize a registered security are typically consolidated subsidiaries of that registrant.

The summarized information may initially be disclosed in a section of the registration statement other than the audited financials, thereby avoiding the delay of an audit. The summarized information includes certain specified line items of the income statement and balance sheet. No additional cash flow information is required, eliminating the difficulty of providing that information at the subsidiary level. The summarized financial information also does not dictate the accounting methods to be used to provide information about separate guarantors, if material. The summarized financial information is required to be supplemented with additional financial information and additional disclosure that would be material to investors. The summarized financial information is required to be presented only for the most recent fiscal year and interim periods thereafter, shortening the current requirements to what the SEC identifies as the most relevant to investors.

The proposed amendments also eliminate the need to provide financial statements for recently acquired entities, deferring instead to the existing requirements of Rule 3-05 of Regulation S-X. Finally, the proposed amendments would require the inclusion of the summarized financial information in periodic reports only so long as the subsidiary would be required to file periodic reports, effectively shortening the period from the existing requirement to provide the information so long as the securities remain outstanding, to the later of one year after the issuance or when the security is no longer held by more than 300 persons.

B. Rule 3-16

The proposed amendments to Rule 3-16 take the same approach as the amendment to Rule 3-10, focusing on simplicity and materiality. The proposed amendments replace the existing requirement that a registrant provide separate financial statements for each affiliate whose securities are pledged as collateral in connection with a debt offering with a requirement that both financial and non-financial disclosures about certain affiliates and the collateral arrangements be made, when material. This shifts the focus from additional financial statements to material non-financial disclosures in order to provide more useful information to investors. The new focus on materiality also eliminates the "significant portion" test for requiring disclosure, which the SEC points out produces anomalous results depending on the amount of debt being issued. Registrants will be required to make disclosures (financial and non-financial) to the holders of the collateralized security whenever that information is material to an investment decision.

Recognizing that affiliates who pledge collateral are almost always consolidated subsidiaries, rather than requiring full audited financial statements for affiliates, the proposed amendment would require summarized financial information when material to the investment decision. If the registrant determines information is not material, the registrant is required to so state and explain its reasons. The proposed amendment would still require full financial statements of unconsolidated affiliates when material to an investment decision. The summarized financial information is presented for the pledging affiliates as a group, rather than for each separate entity and, the SEC explains that since the value of pledged stock necessarily includes the value of consolidated subsidiaries, the summarized financial information consolidates each pledging affiliates' subsidiaries, unlike the proposed approach under Rule 3-10 which only includes specific obligors and not their non-guarantor subsidiaries. The required non-financial disclosures specify certain key items that the SEC posits are the material matters, but the registrant may determine that the specified items are not material and omit them or, if it determines other information is material, then it must include such other information.

IV. Proposed Amendments

A. Rule 3-10

The proposed amendments amend and restate Rule 3-10 in its entirety and create a new Rule 13-01 under Regulation S-X which contains all of the specific disclosure requirements related to the revised Rule 3-10.

An overview of the proposed amendments related to existing Rule 3-10 follows:

- permit the omission of separate financial statements of subsidiary issuers and guarantors when the following conditions are met:
  - the consolidated financial statements of the parent company have been filed;
  - the subsidiary issuer or guarantor is a consolidated subsidiary of the parent company pursuant to the relevant accounting standards (to eliminate the distinction between subsidiaries in corporate form and those in another form and expand the type of subsidiaries that are eligible to omit their financial statements);
  - the guaranteed security is a "debt or debt-like" security[5];
  - one of the following eligible issuer and guarantor structures is applicable (this two-prong framework is meant to replace the five exceptions listed in existing Rules 3-10(b) – (f)):
    - the parent company issues the security or co-issues the security, jointly and severally, with one or more of its consolidated subsidiaries; 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 is guaranteed fully and unconditionally[6] by the parent company; and

- permit the parent company to provide supplemental financial and non-financial disclosure about the subsidiary issuers and/or guarantors and the guarantees that is tailored to the type of information believed to be material to investors to make informed investment decisions about guaranteed debt securities in registered debt offerings ("Proposed Alternative Disclosures"). All of the Proposed Alternative Disclosures will be specified in one place in proposed new Rule 13-01;

- require the Proposed Alternative Disclosures to include:
  - 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;
  - disclosure of summarized financial information for subsidiary issuers and guarantors, including select balance sheet and income statement line items,[7] affected by the factors described above; and
  - any other quantitative or qualitative information that would be material to an investment decision;

- allow the parent company to elect to include the Proposed Alternative Disclosures within or outside of the footnotes to the parent company's audited annual and unaudited interim consolidated financial statements in the registration statement covering the offer and sale of the subject securities and any related prospectus, and in certain Securities Exchange Act of 1934, as amended ("Exchange Act") reports filed shortly thereafter;

[5] "Debt or debt-like" means that (1) the issuer has a contractual obligation to pay a fixed sum at a fixed time and (2) where the obligation to make such payments is cumulative, a set amount of interest must be paid.

[6] To have the same meaning as the "full and unconditional" definition in the current rules. See footnote 2 above.

[7] Per Rule 1-02(bb)(1) of Regulation S-X, the summarized financial information shall include disclosures on current and non-current assets and liabilities, redeemable preferred stock (if applicable), non-controlling 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 particular entity.

- require that, if not in the management's discussion and analysis or the footnotes, then the required disclosures be included in the registration statement immediately after Risk Factors;

- require that the Proposed Alternative Disclosures be included in the footnotes to the parent company's consolidated financial statements for annual and quarterly reports beginning with the annual report for the fiscal year during which the first bona fide sale of the subject securities is completed;

- eliminate the requirement to provide pre-acquisition financial statements of recently-acquired subsidiary issuers and guarantors, as these disclosures would only be required pursuant to the Proposed Alternative Disclosures if material to an investment decision; and

- require the Proposed Alternative Disclosures to continue for as long as the issuers and guarantors have a reporting obligation under Section 15(d) of the Exchange Act with respect to the guaranteed securities (typically the later of one year after the issuance or when the security is no longer held by more than 300 persons), rather than for so long as the guaranteed securities are outstanding.

B. Rule 3-16

The proposed amendments eliminate Rule 3-16 in its entirety and relocate the disclosure requirements about any affiliates whose securities are pledged as collateral and the collateral arrangements to proposed new Rule 13-02 under Regulation S-X.

An overview of the proposed amendments related to existing Rule 3-16 follows:

- require summarized financial information if material to holders of the collateralized security, that covers the most recently-ended fiscal year and year-to-date interim period included in the registrant's consolidated financial statements, which can be provided on a combined (rather than individual) basis for consolidated affiliates;

- require that if any summarized financial information is omitted because it is not material, the disclosure must so state and explain;

- require a description of the terms and conditions of the collateral arrangement and the trading market for any securities pledged as collateral;

- 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; and

- impose the same requirements and provide the same flexibility with regard to placement of the required disclosures in the registration statement and subsequent filings as the proposed amendments to Rule 3-10.

V. Purposes & Effects of Proposed Amendments

The SEC believes that the Proposed Amendments will help to streamline the disclosure process, correct discrepancies with other rules, reduce the costs, paperwork and burdens of reporting and create clearer, more useful and more reliable disclosure for investors.

The SEC expects that the Proposed Amendments would likely lead to an increase in registered debt offerings. Under the existing rules, registered debt offerings can be more costly, time-consuming and cumbersome if guarantees or collateral are to be included; however, under the Proposed Amendments, the streamlined and simplified requirements may open the door for high-yield issuers to see greater benefit in the advantages that come with a registered debt offering over the disadvantages of the burdens and difficulties that they currently have with registered debt offerings under the existing rules. An increase in registered debt offerings may be beneficial to investors as well, as registered debt offerings provide additional disclosures and the disclosures are subject to Section 11 liability. In addition, registered debt offerings allow institutional investors that are not "qualified institutional buyers" ("QIBs") and retail investors to participate in the offering (which is not the case under QIB-only Rule 144A offerings).

With respect to financial statements specifically, the SEC expects that the Proposed Amendments will allow more issuers and guarantors to be eligible to provide the Proposed Alternative Disclosures (as described above) rather than separate financial statements. The SEC recognized that creating separate financial statements is often very difficult and costly for the issuers and guarantors. The SEC was persuaded by commenters who have noted that separate financial statements, along with the existing requirements of Consolidating Information, are usually not viewed as particularly helpful to investors assessing potential offerings, as the focus remains on the issuer/parent company/consolidated financial statements. Further, the SEC expects that the Proposed Alternative Disclosures will be easier for issuers and guarantors to provide and will be significantly more useful to the investors in making risk and investment decisions by focusing on the material information. The SEC expects that investors will not only generally be provided with clearer and more concise information to make investment decisions, but also that this will lead to more efficient pricing procedures and generally get offerings to market more quickly (which will also benefit issuers in being able to more quickly access favorable market conditions).

VI. Conclusion

The overall purpose of the Proposed Amendments is to reduce the burdens and costs of issuers and guarantors, while creating more focused and informative offering documents for the investors making decisions about those offerings. Questions remain regarding whether the Proposed Amendments provide enough clarity for future issuers and guarantors, specifically with respect to the replacement of some requirements and quantitative thresholds with a materiality threshold. The SEC published the Proposed Amendments on July 24, 2018, and the 60-day comment period is in process.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Helene R. Banks at 212.701.3439 or hbanks@cahill.com; Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Douglas S. Horowitz at 212.701.3036 or DHorowitz@Cahill.com; Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; or Alexa Kaminsky at 212.701.3879 or akaminsky@cahill.com.