SEC Proposes Reduction in Financial Reporting Requirements for Guaranteed and Secured Notes

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Commission seeks to encourage registered offerings

On July 24, 2018, the Securities and Exchange Commission proposed **amendments** to the financial disclosure requirements in SEC-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 proposed amendments would reduce the financial disclosure required and focus on information that is material to investors given the specific facts and circumstances of the offering.

We believe the burden of complying with current financial disclosure requirements for guaranteed and collateralized securities has caused most companies to pursue alternatives to registered offerings, such as Rule 144A private placements, in transactions featuring these forms of credit enhancement. If adopted, the proposed amendments should alleviate this burden while at the same time simplifying disclosures for investors. We believe this would encourage many companies to conduct these offerings on an SEC-registered basis.

The proposed amendments would modify Rules 3-10 and 3-16 of Regulation S-X and relocate part of Rule 3-10 and all of Rule 3-16 to new Rules 13-01 and 13-02 of Regulation S-X. The amendments are open for public comment until late September (the exact date depending on when the proposals appear in the Federal Register). Following the formal comment period, the SEC is expected to consider the comments—and possibly amend the rules as a result—before issuing final rules.

The proposed amendments are part of a larger SEC project to examine the effectiveness of its current suite of disclosure requirements, an effort that Congress has pushed through the JOBS Act of 2012 and the FAST Act of 2015. To us, these proposals represent some of the most encouraging ideas yet from this project.

Background

Rule 3-10 generally requires a registration statement to include audited annual and unaudited interim financial statements for all issuers and guarantors of the securities being registered. Additionally, registration of the securities causes each issuer and guarantor to become subject to the public-company reporting requirements of the Securities Exchange Act of 1934. Rule 3-10 provides several exceptions to the general requirement, which are typically available for subsidiaries of a parent company. To omit separate subsidiary financial statements: (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 full condensed consolidating financial information concerning the guarantor and non-guarantor subsidiaries in the parent company's 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 acquiree financial statements, which can

make it especially problematic to use a recently acquired subsidiary as a guarantor or issuer in an SEC-registered securities offering.

Rule 3-16 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 disclosures currently required by Rules 3-10 and 3-16 are usually not provided in Rule 144A private placements. This suggests that the sophisticated offering participants in this robust market do not believe this information to be material, useful or meaningful when making an investment decision. As a result, because producing the currently required financial statements is usually costly and requires a significant amount of time, particularly for an audit, many companies simply forego an SEC-registered offering in favor of a Rule 144A private placement. And particularly with Rule 3-16, some companies may be forced to structure around the requirements in order to effect a registered offering, sacrificing the superior pricing that may otherwise have been obtained.

Proposals

Rule 3-10 / New Rule 13-01

The proposed amendments to Rule 3-10 and new Rule 13-01 provide revised conditions that would need to be met in order to omit separate financial statements of subsidiary issuers or guarantors. These would:

- 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;
- replace the onerous condensed consolidating financial information that must usually be provided by parent companies with summarized financial information, which may be presented on a combined basis (consisting of current and non-current assets, current and non-current liabilities, preferred stock, non-controlling interests, gross revenues, gross profit, income/loss from continuing operations, net income/loss and net income/loss attributable to the entity);
- expand the required qualitative disclosures about the guarantees and the issuers and guarantors, as well as require disclosure of additional information that would be material to holders of the guaranteed securities;
- permit the alternative disclosures to be provided outside the footnotes to the parent company's financial statements—thereby alleviating the time and expense of needing an audit of this information;
- eliminate the requirement to provide pre-acquisition financial statements of recently acquired subsidiary companies and guarantors (so that the only remaining requirement for acquisitions would be the customary requirement to provide separate financial statements and pro formas for recently acquired subsidiaries that are significant under the test used for Form 8-K); and
- require the proposed disclosures 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, rather than for as long as the guaranteed securities are outstanding, as currently required.

Rule 3-16 / New Rule 13-02

The proposed amendments to Rule 3-16 are based 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 is prepared to conclude that separate financial statements of each affiliate whose securities are pledged as collateral are not material in most situations. Accordingly, Rule 3-16 would be amended and relocated to proposed Rule 13-02, which would:

- replace the existing requirement to provide separate financial statements for an affiliate whose securities are pledged as collateral with financial and non-financial disclosures about the affiliate and the collateral arrangements;
- permit the disclosures to be located outside the company's financial statements; and
- replace the requirement to provide disclosure based on the 20% "substantial portion" test with a requirement to provide disclosure in all cases, unless immaterial to holders of the collateralized securities.

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Should the proposed amendments be adopted, the result would be to move disclosure requirements for the financial statements of entities other than the primary obligor closer to the core principles that (i) disclosure requirements should focus on providing material information needed by reasonable investors to make informed investment decisions and (ii) the anticipated benefits of any financial disclosure obligation should outweigh the associated costs. The proposals would result in disclosure that is closer to what is currently included today in Rule 144A private placements. For these reasons, we expect that the proposed amendments, if adopted, will reduce the cost of compliance for companies and encourage companies to offer guaranteed and collateralized securities on an SEC-registered basis.

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