

To the Point

SEC – final rule

SEC streamlines disclosure requirements for certain registered debt offerings

The amendments are intended to encourage companies to conduct registered offerings of guaranteed and collateralized debt securities, which could reduce the cost of capital.

What you need to know

- ▶ The SEC amended its financial disclosure requirements for companies that conduct registered debt offerings involving subsidiaries as either issuers or guarantors and affiliates whose securities are pledged as collateral.
- ▶ The SEC narrowed the circumstances that require separate financial statements of subsidiary issuers and guarantors and streamlined the alternative disclosures required in lieu of those statements.
- ▶ The SEC replaced the requirement for separate financial statements of affiliates whose securities are pledged as collateral for registered securities with requirements similar to those adopted for subsidiary issuers and guarantors.
- ▶ The new disclosures may be located, in all cases, outside of the financial statements.
- ▶ The rule is effective 4 January 2021, but earlier compliance is permitted.

Overview

The Securities and Exchange Commission (SEC or Commission) adopted **final rules** that amend the financial disclosure requirements for subsidiary issuers and guarantors of registered debt securities in Rule 3-10 of Regulation S-X. The SEC also amended the disclosure requirements for affiliates whose securities are pledged as collateral for registered securities in Rule 3-16 of Regulation S-X. The disclosure requirements, as amended, are now relocated to newly created Rules 13-01 and 13-02 in Regulation S-X, while the amended eligibility requirements remain in Rule 3-10. The final rules are largely the same as those proposed by the SEC in July 2018, except for targeted changes made in response to public comments.

The rule changes are intended to encourage companies to conduct registered offerings of guaranteed and collateralized debt securities by making the requirements less burdensome while also providing investors with material information. SEC Chairman Jay Clayton said the final rules “demonstrate how the Commission can modernize its rules and simultaneously increase investor protection, reduce compliance burdens and enhance capital formation.”

Subsidiary issuers and guarantors of registered debt must file their separate audited financial statements required by Regulation S-X, unless an exception is available. The amended rules make it easier for parent companies to qualify for an exception. They also streamline the alternative disclosures that must be provided when such financial statements are omitted. The rules also replace the requirement that a registrant file financial statements of an affiliate whose securities constitute a substantial portion of the collateral of a class of securities registered with the SEC with a less burdensome alternative disclosure requirement.

Key considerations

Omitting separate subsidiary issuer and guarantor financial statements

The amendments allow parent companies to provide alternative disclosures in lieu of separate audited financial statements of subsidiary issuers and guarantors under the following additional circumstances:

- ▶ When a subsidiary is consolidated into the parent company’s financial statements rather than just when the subsidiary is 100% owned by the parent
- ▶ When a subsidiary guarantor is less than fully obligated to pay the debt or, if there are multiple subsidiary guarantors, the guarantees are not joint and several (but a parent company can never be less than fully obligated to receive the disclosure relief)

A description of any factors that may affect payments to holders of guaranteed securities, such as the rights of non-controlling interest holders in consolidated subsidiaries, is required, along with the terms and conditions of the subsidiary guarantees. When these factors differ among the subsidiary issuers and/or guarantors, additional disaggregated financial disclosure is required.

How we see it

Allowing registrants to more broadly omit financial statements of subsidiary issuers and guarantors should lessen the burden of conducting registered debt offerings with guarantees, which could help achieve the SEC’s objective of encouraging more registered offerings.

Streamlined alternative disclosures

Summarized financial information

Registrants are allowed to disclose summarized financial information (SFI), as defined under Rule 1-02(bb) of Regulation S-X, of the issuers and guarantors combined as a group (the obligor group). The disclosure of additional line items is required if it is material for investors to evaluate the sufficiency of the guarantee. At a minimum, SFI must include the following balance sheet and income statement line items:

- ▶ Current assets; noncurrent assets; current liabilities; noncurrent liabilities; and, when applicable, redeemable preferred stocks and noncontrolling interests
- ▶ Net sales or gross revenues, gross profit, income/loss from continuing operations, net income/loss and net income/loss attributable to the group

Defining the obligor group and combined presentation

All eligible subsidiary issuers and guarantors may be combined with the parent company into a single column of SFI, unless further disaggregation is required. The SFI must be presented on a combined basis with intercompany transactions and resulting balances among the entities included in the obligor group eliminated.

Intercompany amounts between the obligor group and non-obligors must remain and be separately identified in the SFI in addition to other related-party transactions and balances. However, the SFI of the obligor group, including any SFI of disaggregated issuers and guarantors, must exclude non-obligor subsidiaries even if those entities are consolidated by entities in the obligor group. That is, an issuer's or guarantor's investment in a subsidiary that is not an obligor must be excluded from the SFI.

How we see it

Requiring the exclusion from the SFI of interests of the obligor group in non-issuers and non-guarantor subsidiaries is a change from the proposal, which would have allowed companies to choose from a variety of methods to reflect these entities (e.g., the equity method). The SEC believes excluding this information from the SFI will result in better comparability. However, since such exclusion is not a method based on any existing accounting or reporting standard or practice, implementation questions may arise.

The amendments streamline the disclosure requirements and simplify compliance.

Periods presented

The rules reduce the periods for which the SFI must be provided from all periods presented in the parent company's financial statements to only the most recent fiscal year and, if applicable, the year-to-date interim period. That is, in quarterly reports for the second and third fiscal quarters, parent companies no longer need to provide the alternative disclosures for the current quarter.

Materiality

Disclosure of additional SFI line items is required if it is material for investors to evaluate the sufficiency of the guarantee. This disclosure threshold is similar to the one required by the previous rules and is a change from the proposed requirement, which was more open-ended.

Disclosure required by the amended rules can be omitted using a different standard of materiality that is consistent with the US Supreme Court's definition. That is, disclosure otherwise required by the rules can be omitted if there is not a substantial likelihood that it would have been viewed by a reasonable investor as having significantly altered the total mix of information made available.

To help registrants evaluate whether they can omit disclosure on the basis it is not material, the SEC identified four non-exclusive scenarios (e.g., the obligor group has no material assets, liabilities or results of operations), in which the required financial information may always be omitted.

How we see it

Providing four safe harbor scenarios in which disclosures may be omitted eliminates the need to assess materiality. While this will make it easier to omit disclosure in these circumstances, companies may be reluctant to omit disclosures not covered by these safe harbors.

Disclosure location

The SEC decided to provide registrants with the flexibility to select the location of the disclosures in all cases. As a result, the rules permit the disclosures to be provided outside of the parent's financial statements in specified areas of a filing, including in management's discussion and analysis. This is a change from the proposal that would have allowed presentations outside of the financial statements only until the annual report covering the year during which the first bona fide sale of the debt security occurred. If the registrant elects to present the information in the annual financial statements, it must be audited.

Recently acquired subsidiary guarantors

The amendments eliminate any requirement to provide separate audited financial statements for a recently acquired subsidiary issuer or guarantor. However, disclosure of pre-acquisition SFI for these entities is required in certain cases when registering the offer and sale of a guaranteed security. Pre-acquisition SFI must be included when a subsidiary issuer or guarantor is acquired after the date of the most recent balance sheet included in the registration statement and is a significant business as defined by Regulation S-X.

Duration of disclosure

The rules permit parent companies to cease reporting the alternative disclosures when the SEC reporting obligations of its subsidiary issuers and guarantors have been suspended or terminated.

How we see it

This represents significant relief for parent companies because the previous rules required ongoing alternative disclosures for as long as the securities were outstanding. This often extended well beyond when reporting obligations could have been suspended or terminated had the disclosure relief not been elected.

Affiliates whose securities are pledged as collateral

The rules eliminate the Rule 3-16 financial statement requirement for affiliates whose securities are pledged as collateral and replaces it with new Rule 13-02, which includes requirements similar to those discussed above for subsidiary issuers and guarantors (e.g., SFI). These disclosures along with certain nonfinancial disclosures also are required if material.

Effective date and transition

The rule is effective 4 January 2021, but earlier compliance is permitted. Reporting parent companies must comply with the final rules in their Exchange Act reports for fiscal periods ending after the effective date, or prospectively in Exchange Act reports for periods ending after a registration statement becomes effective that reflects early compliance with the final rules.