ALERT MEMORANDUM

New SEC Rules on Guaranteed and Collateralized Securities

March 17, 2020

On March 2, 2020, the SEC adopted rule changes to simplify the financial disclosures that are required when an issuer offers debt securities with guarantees.[1] The old requirements were complex, and in some circumstances burdensome, and the utility of some resulting disclosures for investors was doubtful. As discussed below, the new requirements are easier to apply and permit substantially simpler disclosures in some cases.

The SEC also adopted rule changes applicable to a similar, less common situation – securities that are collateralized by a pledge of shares (typically shares of a subsidiary of the issuer).

The new rules have a long transition period. They will become mandatory in 2021 – generally, for a registration statement first filed on or after January 4, 2021 and for a periodic report for a period ending after January 4, 2021. However, earlier compliance is permitted, so an issuer planning a guaranteed or collateralized offering should consider whether to follow the new rules rather than the existing rules. And an issuer that is complying with the existing rules in annual or quarterly reports, because of outstanding guaranteed securities, should consider whether to follow the new rules starting now.

These rule changes are part of the broader Disclosure Effectiveness Initiative, which has produced a long list of reforms in the SEC's disclosure regime since it was announced in late 2013. We are maintaining a Disclosure Simplification Explainer, which you can find here. As with many of the DEI measures, the recent rule changes reflect a regulatory philosophy of moving from detailed prescriptive rules towards principles-based norms that give registrants more flexibility. As

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Nicolas Grabar
+1 212 225 2414
ngrabar@cgsh.com

Katherine M. Clemens
+1 212 225 2321
kclemens@cgsh.com

Stephanie Fontana
+1 212 225 2506
stfontana@cgsh.com

[1] SEC Release No. 33-10762; 34-88307 (March 2, 2020), available at https://www.sec.gov/rules/final/2020/33-10762.pdf.

in several other recent instances, the approach drew a dissent from Commissioner Lee, who characterized these rule changes and others under the DEI rubric as based on unfounded "regulatory intuition" rather than evidence about investor protection.

Guaranteed Debt Securities – The Current Rules

Under the federal securities laws, when a debt security is guaranteed, each guarantee is itself a security, and each guarantor is consequently an issuer. So if the securities are sold in an SEC-registered offering, the full SEC disclosure regime potentially applies to the issuer and each guarantor.

Often, the issuer and the guarantors are all part of a consolidated group – for example, when a finance subsidiary is the issuer and the parent provides a guarantee, or when the parent is the issuer and one or more operating subsidiaries provide guarantees. In these cases, the SEC recognizes that investors rely principally on the consolidated financial statements, and only need supplemental information about the subsidiary issuers and guarantors. It also recognizes that requiring separate disclosures from multiple entities in a consolidated group is burdensome and tends to drive securities offerings from the public markets to private placements.

Rule 3-10 of Regulation S-X, adopted in its current form in 2000, is based on this recognition. To avoid unnecessary disclosures, current Rule 3-10 provides exemptions from the general requirement that the issuer and each guarantor must comply separately with all the disclosure and reporting requirements applicable to an issuer. These exemptions have, however, proven unwieldy in several respects.

— 100% Ownership. The exemptions are only available if each subsidiary issuer and guarantor is "100%-owned" by the parent company. This excludes many common fact patterns in the structure of corporate groups.

— The Consolidating Footnote. In many circumstances, the exemptions require the parent company to present condensed consolidating financial information, with separate columns for issuers, guarantors and non-guarantors.

- If this information is required, it must be in the footnotes to the audited financial statements and interim financial statements – a "Consolidating Footnote". When a new offering is under consideration but the previously published financial statements do not contain the Consolidating Footnote, the audited consolidated financial statements would need to be re-issued to include the footnote, generally with a double dated audit report.
- If the Consolidating Footnote is required, it must be presented in subsequent quarterly and annual reports under the Exchange Act for so long as the securities are outstanding.

— Omitting the Consolidating Footnote. The Consolidating Footnote can be replaced by a brief narrative explanation in three cases:

- the securities are issued by a finance subsidiary, and the parent is the only guarantor – so the only material obligor is the parent;
- the securities are issued by a subsidiary and guaranteed by the parent, the parent is a holding company, and there are no other subsidiaries other than "minor" subsidiaries – so the obligors include essentially the entire corporate group; and
- the parent is a holding company, and all its subsidiaries other than "minor" subsidiaries are guarantors – so, again, the obligors include essentially the entire corporate group.

— New Subsidiaries. Where a reporting company acquires a new subsidiary issuer or guarantor, in specified circumstances, current Rule 3-10 requires the acquirer to present separate audited pre-acquisition financial statements of the new subsidiary in the registration statement.

Guaranteed Securities – The New Rules

Amended Rule 3-10 permits financial statements of a subsidiary issuer or guarantor of securities to be omitted if all of the following conditions are met:

— The parent consolidates the subsidiary. This represents a substantial relaxation from current Rule 3-10, under which omission of separate financial statements was only available if the subsidiary was 100%-owned by the parent.

— The consolidated financial statements of the parent have been filed and the parent is an Exchange Act reporting company (or will become one as a result of the offering).

— The parent issues or co-issues the securities with the subsidiary, or the parent guarantees the securities fully and unconditionally. In contrast to existing Rule 3-10, the new rule does not turn on whether a subsidiary's obligations as guarantor are "full and unconditional".

— The securities are "debt or debt-like" – an expression defined in the amended rule and consistent with the guidance under the current rule.[2]

— The parent provides disclosures specified in a new Rule 13-01.

The disclosures required by Rule 13-01, in turn, depend on the circumstances.

— Narrative Disclosures. Rule 13-01 requires three specific types of narrative disclosures in both registration statements and subsequent Exchange Act reports. Each of these is qualified by the introductory words "to the extent material." There was no specific rule requiring these disclosures in the past, but in our experience information along these lines has routinely been provided in offering documents and, to some extent, in footnotes to financial statements, capital resources discussions in MD&A and risk factors.

- A description of the issuers and guarantors.
- A description of the terms of the guarantees, and of how payments may be affected by the structure of the corporate group.
- A description of other factors that may affect payments, such as restrictions on dividends, enforceability of guarantees, subsidiary guarantee release provisions, or rights of minority shareholders in subsidiaries.

— Subsidiary Guarantor Exhibit. The amendments add a new exhibit requirement to Item 601 of Regulation S-K for registration statements and Forms 10-K, 10-Q and 20-F: a list that identifies each of the parent company's subsidiaries that is a guarantor, issuer or co-issuer for each applicable guaranteed security. The original proposal required this information as part of the narrative disclosures under Rule 13-01, but the SEC moved it to an exhibit in list format at the suggestion of a commenter.

— Summarized Financial Disclosures. New Rule 13-01 requires financial information on subsidiary guarantors and issuers with a more manageable scope and format than the Consolidating Footnote under current Rule 3-10.

- Information about whom? The rule requires summarized financial information for all obligors, which may be presented as a group, on a combined basis – eliminating intracompany balances and transactions within the group and excluding investments by obligors in non-obligors. In contrast to current Rule 3-10, there is no requirement to show information for non-guarantors or to show the "consolidating" table (how all the obligors and non-obligors add up to the consolidated totals).

[2] Under amended Rule 3-10(b)(2): "A security is "debt or debt-like" if it has the following characteristics: (i) The issuer has a contractual obligation to pay a fixed sum at a fixed time; and (ii) Where the obligation to make such payments is cumulative, a set amount of interest must be paid." A note to the Rule specifies that "a set amount of interest" can include interest at floating or adjustable rates.

If there are material differences among obligors in the terms of the guarantees and other factors that may affect payment, the summarized information should be presented separately, unless the differences can be easily explained and understood in narrative disclosure (which the SEC suggests would be in limited circumstances). Issuers should consider materiality when determining the appropriate level of aggregation.

- How much information? For the scope of the information, Rule 13-01 refers to the summarized financial information requirements under Regulation S-X, which are familiar because they apply to certain required footnote disclosures (such as equity method investees). Notably, in contrast to current Rule 3-10, there is no requirement to present cash flow information.
- For what periods? The information is required for the most recent fiscal year and year-to-date interim period included in the parent financial statements. In contrast to current Rule 3-10, there is no requirement to present information for earlier comparative periods or for the most recent quarter.

— Omitting the Summarized Financial Disclosures. The new Rule 13-01 only requires disclosures, including the summarized financial disclosures, to the extent material. In addition, as under current Rule 3-10, there are specified circumstances where the new Rule 13-01 permits the summarized financial information to be omitted.

- The new Rule provides non-exclusive examples of circumstances in which the summarized financial information can be omitted:
  - if the parent company's consolidated financial statements do not differ in any material respects from the combined issuers and guarantors;
  - if the combined issuers and guarantors have no material assets, liabilities or results of operations, excluding investments in subsidiaries; and
  - if the issuer is a finance subsidiary and the parent fully and unconditionally guarantees the debt (or is a co-issuer). The definition of "finance subsidiary" under new Rule 13-01 is substantially the same as under current Rule 3-10.
- The adopting release describes these examples as the most common situations under which the summarized financial disclosures would not be material. However, an issuer can also omit the summarized financial information based on its own determination that the information would not be material. This principles-based approach does not provide the certainty of a numerical threshold, and it will require judgment, but the SEC expects it to allow issuers to provide more tailored and relevant disclosures to address the needs of investors.

— Location. Rule 13-01 provides flexibility on where to include the required disclosures. They can be included in a footnote to the audited financial statements, as under current Rule 3-10, but alternatively they may be included in MD&A. In a prospectus, if they are not otherwise included or incorporated by reference, they must immediately follow "Risk Factors" or pricing information. The ability to present required information outside the financial statements (and therefore outside the scope of the audit) in both registration statements and periodic reports is an important element of flexibility compared to the former rule.

— Treatment of Newly Acquired Subsidiaries. Rule 13-01 eliminates the requirement under current Rule 3-10(g) to include in a registration statement separate pre-acquisition financial statements for certain subsidiary issuers or guarantors that are significant. Instead, if the parent company has acquired a significant "business" after the most recent balance sheet date in the registration statement, Rule 13-01 requires pre-acquisition

summarized financial information for any of the new subsidiaries that will be issuers or guarantors of the securities being offered. This will better align this requirement with other rules under Regulation S-X, although in some cases the summary information may be required before the financial statements would need to be filed under Rule 3-05. Whether an acquisition is of a "business" is determined in the same way as for pro forma financial statement requirements, and significance for this purpose is measured at the 20% level under the familiar Regulation S-X definition of significance.[3]

— Catch-all. Rule 13-01 has two catch-all provisions requiring disclosure of any information material to evaluate the sufficiency of the guarantee, and requiring sufficient information to make what is presented not misleading.

The ongoing disclosure obligations under the new rule will, for some issuers, terminate much earlier than under the current rule. In contrast to current Rule 3-10, which requires the information to be included for as long as the guaranteed securities are outstanding, the disclosure obligations in new Rule 13-01 with respect to a class of securities can be suspended after the first annual report on Form 10-K or Form 20-F following the issuance, if the securities of that class are held by fewer than 300 holders of record.

Collateralized Securities

The SEC applied similar reasoning in amending the disclosure requirements for securities that are collateralized by a pledge of shares of the issuer's subsidiary. Current Rule 3-16 requires separate financial statements for an affiliate of a registrant where that affiliate's shares constitute a substantial portion (defined as 20% or more) of the collateral package for the registrant's securities. But when the affiliate is a consolidated subsidiary and debtholders can only foreclose on the shares in an event of default, as is usually the case for these securities, investors primarily rely on the issuer's financial statements when making an investment decision.

The amendments replace the requirement for separate financial statements under Rule 3-16 with new Rule 13-02, requiring financial and narrative disclosures about the relevant subsidiaries and the collateral arrangements. Rule 13-02 replaces the bright-line 20% test with a materiality standard. Its disclosure requirements are generally equivalent to those in new Rule 13-01 for guaranteed securities, including the new exhibit.

A notable difference compared to current Rule 3-16 is that the ongoing disclosures will now be required in the parent's quarterly reports on Form 10-Q; current Rule 3-16 only requires separate financial statements in registration statements and annual reports.

Commenters on the proposed amendments pointed out that the elimination of Rule 3-16 could have unintended consequences, because indentures for collateralized securities often contain provisions that permit collateral to be released if Rule 3-16 disclosures are triggered. To avoid causing changes in collateral packages, the amendments leave Rule 3-16 in place for registered securities issued before January 4, 2021, unless the registrant was already providing financial statements pursuant to Rule 3-16.

Takeaways

SEC registrants with outstanding guaranteed or collateralized securities will need to review the new rules closely. For many of them – issuers of guaranteed securities that are not currently required to provide a Consolidating Footnote under Rule 3-10 – the impact of the new rule will probably be minor. For those that are providing a Consolidating Footnote, however, the new rules will significantly ease the burden of compliance. And for some issuers, the new rules will shorten the duration of the obligation to provide additional disclosures. Issuers in a position to

[3] To the extent these rules are changed pursuant to amendments proposed by the SEC in May 2019, the adopting release confirms that the triggers in Rule 13-01 will be conformed.

benefit should consider whether to comply with the new rules early.

For some issuers contemplating a new offering of guaranteed or collateralized securities, the new rules will remove important drawbacks to proceeding on a registered basis as opposed to a Rule 144A private placement. It will be interesting to see whether they tip the balance in favor of the public markets in a substantial number of cases.

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