

CAPITAL MARKETS

SEC Eliminates Consolidating Financial Information for SEC-Registered Debt Securities with Subsidiary Issuers or Guarantors

Amendments eliminate audited three-year guarantor financial statement footnote and separate financial statements of subsidiaries whose shares are pledged; replaced with unaudited combined summarized financial information for most recent year and interim period

On March 2, 2020, the Securities and Exchange Commission released its final amendments to the rules governing the supplemental financial information required for SEC-registered debt securities that have guarantees or that are collateralized by shares or other securities of subsidiaries or other affiliates. These amendments significantly reduce the amount of financial information required for those securities in addition to the parent company's consolidated financial statements. They provide welcome relief to repeat issuers of registered debt securities with subsidiary issuers or guarantors and to all companies that have outstanding guaranteed debt securities previously issued in registered offerings or with registration rights. The amendments will become effective on January 4, 2021, but the SEC has expressly permitted voluntary compliance with the new rules before then.

With respect to guaranteed securities, the amendments eliminate the requirement to include detailed consolidating financial information in the parent company's annual and interim financial statements, sometimes referred to as the "guarantor footnote." The amendments replace this consolidating financial information with summarized financial information that includes more limited balance sheet and income statement line items, is presented on a combined basis for the parent company and all subsidiary issuers and guarantors, covers only the most recent annual and year-to-date interim period, and can be unaudited. The amendments also eliminate the condition that each subsidiary issuer or guarantor must be 100%-owned by the parent company, which has affected registrants with noncontrolling interests, substituting a requirement that each subsidiary issuer or guarantor be consolidated in the parent company's financial statements.

For securities secured by pledges of shares or other securities of affiliates, typically subsidiaries, of the registrant, the amendments remove the existing requirement to provide separate financial statements of those affiliates if the pledged securities represent a numerically substantial portion of the collateral. Instead, registrants will have to file combined summarized financial information for affiliates whose securities are pledged, if material.

We supported many of the amendments in a [comment letter](#) we submitted when the SEC initially [proposed](#) the amendments last year, in which we also provided the SEC with suggestions for additional refinements. We believe that the amendments succeed in reducing the reporting burden on registrants while still providing the information necessary for the protection of investors.

Guaranteed Debt Securities—Rule 3-10

Under existing Rule 3-10 of Regulation S-X, every issuer of a guaranteed registered security and every guarantor of a registered security must file a complete set of financial statements required for a registrant. In practice, it is very rare for subsidiary issuers or guarantors to file their own separate financial statements. These parent-subsidary structures typically qualify for an exception to this rule that allows for consolidating financial information instead if they meet two conditions: (i) each subsidiary issuer and guarantor must be “100% owned” by the parent company; and (ii) each guarantee must be “full and unconditional.”

The amendments adopted by the SEC substantially modify the conditions for this exception, as well as the content and location of the financial and non-financial disclosures. The following is a list of the most significant of these modifications:

- Consolidating financial information for three years and interim period is eliminated and replaced with summarized financial information on a combined basis for the most recent year and year-to-date interim period.
- Unlike the consolidating financial information, the new summarized financial information can be provided outside the financial statements and can be unaudited.
- Subsidiary issuers or guarantors no longer need to be 100%-owned, and subsidiary guarantees no longer need to be “full and unconditional.”
- Non-financial disclosures about the guarantors and the guarantees are expanded.
- A materiality exception replaces numerical thresholds for disclosure.
- Separate financial statements of recently acquired subsidiary issuers or guarantors are eliminated and replaced by summarized financial information which is only required if the acquisition is significant.
- Companies will be able to suspend ongoing reporting of summarized financial information if certain conditions are met.

As noted above, the amendments will become effective on January 4, 2021, but the SEC has expressly permitted earlier voluntary compliance. Effectiveness and transition considerations are also discussed further below. We expect that most companies that currently include consolidating financial information in their periodic reports will choose to adopt the amendments early in order to benefit from the less burdensome requirements.

Consolidating financial information for three years and interim period is eliminated and replaced with summarized financial information on a combined basis for the most recent year and year-to-date interim period

Existing Rule 3-10 requires filing of detailed consolidating financial information that includes all major captions of the balance sheet, income statement and cash flow statement that would be included in full financial statements. The information needs to include all of these line items in separate columns for the parent company (standalone), all of the subsidiary guarantors (combined), all of the non-guarantors (combined), a separate subsidiary issuer, if

any (standalone), consolidating adjustments, and the consolidated total. The amendments replace this with the following summarized financial information:

- **Summarized financial information with more limited line items.** By requiring only “summarized financial information,” the amendments reduce the number of balance sheet and income statement captions that the financial information needs to include and eliminate the need for cash flow information. For the balance sheet, summarized financial information is limited to current assets, noncurrent assets, current liabilities, noncurrent liabilities, and, when applicable, redeemable preferred stocks and non-controlling interests. For the income statement, the information consists of net sales or gross revenues, gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues), income or loss from continuing operations, net income or loss, and net income or loss attributable to the entity. Specialized industries can substitute certain line items. The SEC noted that the disclosure of additional line items may be required where the parent company concludes that it would be material for evaluating the sufficiency of the guarantee. In addition, the amended rules require an issuer’s or guarantor’s amounts due from, amounts due to, and transactions with non-obligated subsidiaries and related parties to be presented in separate line items in the summarized financial information, to the extent material.
- **Combined presentation.** The amendments permit the summarized financial information to be presented on a combined basis for the parent company and all subsidiary guarantors or subsidiary issuers given that holders of the debt securities will have recourse to all of these entities. No information will need to be presented for any non-guarantor/non-issuer subsidiaries, but those subsidiaries must be completely excluded from the summarized financial information, even if an issuer or guarantor would otherwise consolidate such non-guarantor/non-issuer subsidiaries. As a result, the investments that the obligors hold in the non-obligor subsidiaries will not be included in the combined summarized financial information of the obligors. This is different from the instructions under existing Rule 3-10, which mandate that investments in non-guarantors be presented using the equity method of accounting. Separate presentation of the summarized financial information may be required if there are non-financial disclosures that apply only to some but not all issuers or guarantors, as further discussed below.
- **Only most recent fiscal year and interim period.** The summarized financial information under the amendments is only required as of, and for, the most recently ended fiscal year and year-to-date interim period, if applicable and without information for the corresponding interim period in the prior year. Under the existing rules, the consolidating financial information was required to cover all three fiscal years and the most recent interim period, including quarter-to-date if applicable and comparable prior year period.

Required financial information can be provided outside the financial statements and can be unaudited

Currently, the required consolidating financial information (and any non-financial information) must be included in the notes to the parent company’s consolidated financial statements. This means that the information is subject to an audit or review by the parent company’s auditors. Under the amendments, companies have the following considerations:

- **Choice between financial statements and MD&A.** The amendments permit the parent company to present the summarized financial information and the non-financial disclosures in a note to its consolidated financial statements or alternatively in the MD&A. If the disclosures are not otherwise included in the financial statements or in the MD&A (for example, because the financial statements and MD&A are incorporated from periodic reports that do not include that information), they must be included in the prospectus immediately following “Risk Factors,” if any, or otherwise immediately following the pricing information. This flexibility regarding the location of the required

disclosures in either financial statements or MD&A applies equally to registration statements and offerings and to subsequent periodic reports.

- **Considerations for location of disclosure.** When parent companies choose to include the relevant information in the notes to their consolidated financial statements, it will be subject to annual audit, interim review, internal control over financial reporting and XBRL tagging requirements. Presentation of the information outside the financial statements means that it will be unaudited. Locating the disclosures in the financial statements may therefore require additional work and expense at the time the financial statements are prepared, but may reduce the amount of work still to be performed at the time of an offering and may be associated with a higher level of comfort.

Subsidiary issuers or guarantors no longer need to be 100%-owned, and subsidiary guarantees no longer need to be “full and unconditional”

A condition for omitting separate subsidiary issuer or guarantor financial statements, both under the existing rules and under the amendments, is that the parent company whose filings include the required alternative disclosures is the issuer or guarantor of the debt securities. The new rules provide for the following:

- **Less than 100%-owned subsidiary issuers and guarantors permitted.** The amendments define “parent company” to mean an entity that consolidates each subsidiary issuer and guarantor in its consolidated financial statements. This revision addresses situations where parent companies with consolidated but less than 100%-owned subsidiaries were previously not permitted to omit the subsidiary issuer or guarantor financial statements, potentially resulting in issuers failing to designate such entities as guarantors, issuing debt without a guarantee, or avoiding registration altogether.
- **“Full and unconditional” subsidiary guarantees no longer required.** The amendments eliminate the condition that any subsidiary guarantee must be “full and unconditional,” but require that the terms and conditions of the guarantee be disclosed. This includes any limitations, whether the guarantee is joint and several with other guarantees, and any guarantee release provisions, each to the extent material.
- **Parent company guarantee still full and unconditional.** The amendments do not change the condition that the parent company, if it is not the issuer or co-issuer of the securities, must guarantee the securities and that its guarantee must be “full and unconditional.”

Non-financial disclosures about guarantors and guarantees are expanded

Under the existing rules, if the parent company includes the required consolidating financial information in its consolidated financial statements, only limited non-financial disclosures are required. These currently consist of statements that each subsidiary guarantor or subsidiary issuer is 100%-owned by the parent company, that all guarantees are full and unconditional, and that all guarantees are joint and several. Under the new rules, the following non-financial disclosures are required:

- **Enhanced non-financial disclosures.** The amendments require enhanced narrative disclosure about the issuer and guarantors, the terms and conditions of the guarantees, and how the issuer and guarantor structure and other factors may affect payments to holders of the guaranteed securities. Examples include how payments to holders may be affected by the composition of and relationships among the issuers, guarantors and non-guarantors and factors such as restrictions on dividends or guarantee enforceability. The amendments also provide that when a non-financial disclosure is applicable to one or more, but not all, issuers and guarantors, the parent company must disclose, to the extent it is material, separate summarized financial information for the issuers and guarantors to

which the relevant non-financial disclosure applies. The SEC suggested that it may be appropriate to aggregate summarized financial information for the affected issuers and guarantors, taking into account quantitative factors, such as the financial significance of the affected issuers and guarantors, as well as qualitative factors.

- ***New exhibit listing subsidiary issuers and guarantors.*** While the disclosure itself will need to contain only a description, rather than an identification, of the issuers and guarantors of the guaranteed security, the amendments create a new exhibit for subsidiary issuers and guarantors that parent companies must file with their periodic reports. This exhibit must list each of the relevant subsidiaries under an appropriate caption that identifies the associated securities and the entity's role as issuer, co-issuer or guarantor.
- ***Additional information.*** The SEC retained the existing requirements to disclose financial and narrative information about each guarantor if the information would be material for evaluating the sufficiency of the guarantee and to disclose sufficient information to make the presented information not misleading.

Materiality exception replaces numerical thresholds for disclosure

The existing regime permits parent companies to omit the consolidating financial information altogether if certain numerical thresholds are met, including that the parent company has “no independent assets or operations” and that all non-issuer and non-guarantor subsidiaries are “minor.” A parent company is deemed to have no independent assets or operations if each of its total assets, revenues, income from continuing operations before income taxes, and cash flows from operating activities (excluding amounts related to its investment in its consolidated subsidiaries) is less than 3% of the corresponding consolidated amount. A subsidiary is considered minor if each of its total assets, stockholders' equity, revenues, income from continuing operations before income taxes, and cash flows from operating activities is less than 3% of the parent company's corresponding consolidated amount. These requirements are replaced in the amendments by the following:

- ***Materiality standard.*** The amendments eliminate these numerical thresholds and instead permit companies to omit some or all of the summarized financial information and non-financial disclosures required under the new rules on the basis that they are not material. The SEC expressly acknowledged that the summarized financial information goes beyond the more limited information typically provided in Rule 144A debt offerings. Although issuers and underwriters in the Rule 144A market have long been comfortable with this more limited information, we do not believe that the SEC will necessarily permit companies to apply the same materiality standard in registered offerings.
- ***Materiality safe harbors.*** While the SEC did not separately define materiality for this purpose, it did identify the following four non-exclusive scenarios in which the summarized financial information could be omitted on the basis that it is not material, provided the applicable scenario is disclosed to investors:
 - The assets, liabilities and results of operations of the combined issuers and guarantors of the guaranteed security are not materially different than corresponding amounts presented in the consolidated financial statements of the parent company;
 - The combined issuers and guarantors, excluding investments in subsidiaries that are not issuers or guarantors, have no material assets, liabilities or results of operations;
 - The issuer is a finance subsidiary of the parent company, the parent company has fully and unconditionally guaranteed the security, and no other subsidiary of the parent company guarantees the security; or

- The issuer is a finance subsidiary that co-issued the security, jointly and severally, with the parent company, and no other subsidiary of the parent company guarantees the security.

The SEC believes that these four scenarios encompass most of the situations under which the required financial information would not be material, but it also emphasized that they are not intended to be exclusive. Under the SEC's principles-based approach, there may be other scenarios where a parent company concludes that the summarized financial information is not material and can be omitted.

Separate financial statements of recently acquired subsidiary issuers or guarantors are eliminated and replaced by summarized financial information which is only required if the acquisition is significant

Under existing Rule 3-10, pre-acquisition financial statements of recently acquired subsidiary issuers and guarantors are required in a registration statement if the subsidiary has not been included in the audited consolidated results of the parent company for at least nine months and the net book value or purchase price, whichever is greater, of the subsidiary is 20% or more of the principal amount of the securities being registered.

The amendments eliminate this requirement and replace it with a disclosure of summarized financial information for certain recently acquired subsidiary issuers and guarantors. This will apply only in connection with acquisitions that occur after the date of the parent company's most recent balance sheet included in the consolidated financial statements and that are so "significant" to the parent company that they trigger a need to present pre-acquisition financial statements of the acquired business under the SEC's rules for acquired company financial statements.

Companies will be able to suspend ongoing reporting of summarized financial information if certain conditions are met

Selling guaranteed debt securities in a registered offering currently triggers required financial and non-financial disclosures not just in the relevant registration statement and at the time of the offering, but also on an ongoing basis as part of the parent company's periodic SEC reporting for as long as the guaranteed securities are outstanding.

The amendments will permit parent companies to cease including the summarized financial information and any related non-financial disclosures in their periodic reports once the relevant subsidiary issuers and guarantors have properly suspended their own SEC reporting obligations. Suspension should be available if the relevant class of securities has fewer than 300 holders of record, the subsidiaries do not have any listed securities, and the suspension does not relate to the year in which the registration statement became effective. In our experience, guaranteed debt securities typically have fewer than 300 holders of record per class. As a result, absent contractual undertakings to the contrary, parent companies should often technically be able to stop including the supplemental information in their periodic reports for any year other than the one in which the relevant registration statement became effective if they correctly implement the suspension.

In practice, companies that want the flexibility to access the debt markets again with a registered offering of guaranteed securities on short notice may well decide not to suspend the relevant SEC reporting obligations and instead keep including the relevant supplemental information in their reports so it is ready for use in connection with a new offering.

Effectiveness and early adoption

The amendments become effective on January 4, 2021 and compliance with the new disclosure requirements will be mandatory for registration statements, including post-effective amendments filed to update the audited financial statements, that are filed on or after that date. Exchange Act reports need to comply with the new rules only for fiscal years ending after January 4, 2021 (but may need to comply sooner if incorporated into registration statements). Voluntary compliance with the final amendments in advance of January 4, 2021, will be permitted. After voluntary compliance, subsequent Exchange Act periodic reports must comply with the new rules.

Pledges of Securities of Affiliates as Collateral for Debt Securities—Rule 3-16

Existing Rule 3-16 of Regulation S-X requires a registrant to provide separate financial statements for each affiliate whose securities have been pledged and constitute a “substantial portion” of the collateral for any class of registered collateralized securities as if the affiliate were a separate registrant. Rule 3-16 would potentially apply in offerings of secured notes where the shares of subsidiaries are pledged as collateral. The pledged affiliate securities are deemed to constitute a substantial portion of the collateral if the highest amount among the aggregate principal amount, par value, book value, or market value of the affiliate securities equals or exceeds 20% of the principal amount of the registered securities. The amendments modify this in several ways:

- **Materiality analysis in lieu of numerical threshold.** The amendments eliminate the numerical “substantial portion” test and replace it with a requirement to provide all disclosures specified in the rule unless such information is not material. The SEC did not define materiality for this purpose but did establish a safe harbor of scenarios where it deems the information not material. This safe harbor is described further below.
- **Summarized financial information.** The amendments to Rule 3-16 replace the requirement for separate financial statements with a requirement to include summarized financial information of the relevant affiliates in the applicable filings of the parent company registrant. The amended rules assume that the affiliate whose securities have been pledged will almost always be a consolidated subsidiary of the registrant. While the amended rules do not contain a specific requirement to include additional information in circumstances where that is not the case, the SEC indicated that in those circumstances it would expect disclosure beyond the summarized financial information, including potentially separate financial statements of the unconsolidated affiliate.
- **Combined presentation.** The summarized financial information is permitted to be provided on a combined basis for all affiliates whose securities have been pledged. This summarized financial information will include all subsidiaries that would be consolidated by those affiliates, even if the securities of those subsidiaries are not also pledged as collateral. As an exception to the rule of combined presentation, separate presentation may be required when certain non-financial information, such as the relevant trading market for the pledged securities or enforcement standstills or other limitations, apply only to the pledged securities of certain affiliates but not others.
- **Periods presented.** The summarized financial information will be required only for the most recently ended fiscal year and year-to-date interim period included in the registrant’s consolidated financial statements. Following the initial registration, this information will need to be updated with each quarterly report. In contrast, the separate financial statements of the relevant affiliates required under the existing rule are provided only annually, but not in quarterly reports.

- **Materiality safe harbor.** The SEC identified the following non-exclusive scenarios in which the summarized financial information could be omitted on the basis that it is not material, provided the applicable scenario is disclosed to investors:
 - The assets, liabilities and results of operations of the combined affiliates whose securities are pledged as collateral are not materially different than the corresponding amounts presented in the consolidated financial statements of the registrant; or
 - The combined affiliates whose securities are pledged as collateral have no material assets, liabilities or results of operations.

The SEC stated its belief that these scenarios encompass most of the situations under which the required financial information would not be material, but also emphasized their non-exclusive nature and that there may be other scenarios where the registrant may conclude that summarized financial information is not necessary.

- **Other provisions.** The amendments also contain a number of other provisions that generally mirror the corresponding provisions in the amended rules governing guaranteed debt securities. These include provisions about enhanced non-financial disclosures and additional information that may be material for evaluating the pledge or necessary to make any other information not misleading, the location of the required information, a new exhibit listing the affiliates whose securities have been pledged and identifying the pledged securities, among others. In an effort to harmonize the rules for securities secured by affiliate securities pledged as collateral with those for guaranteed securities, the SEC also included a requirement for pre-acquisition summarized financial information for recently acquired affiliates if the acquisition was significant.
- **Effectiveness and transition.** The effectiveness of the amendments to Rule 3-16 generally follows the same principles as those for the amendments to Rule 3-10. However, there is a difference related to so-called 3-16 collateral release or cut-back provisions. These are provisions included in the documentation that limit the amount of affiliate securities being pledged so that they constitute less than a “substantial portion” of the collateral that would trigger the financial statement requirements of Rule 3-16. In light of the prevalence of these provisions in registered secured debt securities, the SEC decided that existing Rule 3-16 will continue to apply to registered securities issued and outstanding before January 4, 2021 for which the registrant has not previously been required to provide Rule 3-16 financial statements. This will prevent the amendments from changing the collateral available to holders.

Conclusion

The amendments we just discussed meaningfully reduce the reporting burden on companies accessing the registered debt market with subsidiary issuers or guarantors, while still providing the information necessary for the protection of investors. They also give companies more flexibility in executing secured bond financings through registered offerings. Overall, they represent an important milestone in the SEC’s disclosure effectiveness project. However, we do not anticipate that the amendments will change disclosure practices in the Rule 144A for life market or shift new issuance from that market to the SEC-registered market to any significant extent.

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