

# Memorandum

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## SEC Proposes Changes to Simplify and Streamline Financial Disclosure Requirements in Certain Registered Debt Offerings

August 20, 2018

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On July 24, 2018, the Securities and Exchange Commission proposed amendments to Rules 3-10 and 3-16 of Regulation S-X designed to simplify and streamline the financial disclosure requirements applicable to subsidiary guarantors and issuers of registered debt securities, as well as for affiliates whose securities are pledged in favor of holders of a registrant's debt securities. The proposed amendments are intended to make these disclosures easier for investors to understand while reducing the compliance burden for registrants, which the SEC hopes will encourage additional registered debt offerings.<sup>1</sup> Following a 60-day comment period, the SEC intends to publish final rules.

### Background of Rules 3-10 and 3-16

Rules 3-10 and 3-16 require certain disclosures in connection with registered debt offerings and subsequent periodic reporting.

Currently, in the absence of relief, every issuer and guarantor of a registered security must include in the applicable registration statement under the Securities Act of 1933 the audited annual and unaudited interim financial statements required for a registrant by Regulation S-X, as well as become subject to ongoing SEC reporting requirements under the Securities Exchange Act of 1934 (the "Exchange Act"). Rule 3-10 provides exceptions to this general rule. If the conditions to any one of these exceptions are met, the separate financial statements of each guarantor (or subsidiary issuer) may be omitted from the registration statement, and such entities shall be exempt from ongoing Exchange Act reporting, provided that the parent company (whether an issuer or a parent guarantor) provides certain alternative disclosures about the relevant subsidiaries. The two principal conditions that must be satisfied for subsidiary issuers and guarantors to

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<sup>1</sup> See *Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities*, Release No. 33-10526; 34-83701; File No. S7-19-18 (July 24, 2018).

omit their financial statements are: (i) the entity must be 100% owned by the parent company and (ii) in the case of a subsidiary guarantor, the guarantee must be full and unconditional. The alternative disclosure mandated by current Rule 3-10 is generally in the form of highly detailed condensed consolidating financial information included as a note to the parent company's consolidated financial statements, which must be included in the applicable registration statement as well as the parent company's periodic Exchange Act reports for as long as the guaranteed securities are outstanding.

Additionally, under current Rule 3-10, a parent company must also include separate pre-acquisition financial statements for recently-acquired subsidiary issuers or guarantors if such entities are significant and have not been reflected in the parent company's results for a specified period of time. A subsidiary is deemed significant for this purpose if the greater of its net book value or purchase price is 20% or more of the principal amount of the securities being registered.

Similarly, in the case of offerings of secured debt, current Rule 3-16 requires a registrant to provide separate financial statements for each affiliate whose securities constitute a substantial portion of the collateral. The test to determine whether an affiliate's collateral represents a "substantial portion" is to compare 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. If the highest of those values for any fiscal year presented by the registrant equals or exceeds 20% of the principal amount of the securities registered, separate financial statements are required to be presented (the "Substantial Portion Test").

### **Proposed Amendments to Rule 3-10**

The SEC's proposed amendments to Rule 3-10 include:

- Replacing the condition that a subsidiary issuer or guarantor be 100% owned by the parent company with the condition that such entity merely be consolidated in the parent company's consolidated financial statements;
- Replacing the requirement to provide condensed consolidating financial information with summarized financial information of the issuers and guarantors, which may be presented on a combined basis, and reducing the number of periods presented;
- Expanding required qualitative disclosure about the guarantees, the issuers and guarantors, as well as other related information that is material to investors;
- Permitting these alternative disclosures to be provided outside the notes to the parent company's financial statements in the registration statement and in Exchange Act reports filed thereafter;
- Eliminating the requirement to provide pre-acquisition financial statements of recently-acquired subsidiaries; and

- Requiring the proposed alternative disclosures only for as long as there is an Exchange Act reporting obligation with respect to the guaranteed securities instead of for as long as the guaranteed securities are outstanding.

The amendments would move these disclosure obligations to new Rule 13-01.

### Proposed Amendments to Rule 3-16

The SEC's proposed amendments to Rule 3-16 include:

- Replacing the requirement that a registrant provide separate financial statements for each affiliate whose securities are pledged as collateral and that meets the Substantial Portion Test with a requirement that the registrant provide financial and non-financial disclosures about the affiliate and the collateral arrangement unless such affiliate is immaterial to the holders of the collateralized security; and
- Permitting the disclosures to be provided outside the notes to the parent company's financial statements.

The amendments would move these disclosure obligations to new Rule 13-02.

### Impact of Proposed Amendments

The proposed rule amendments are intended to enhance the attractiveness of SEC-registered offerings of guaranteed and/or secured debt, which are frequently avoided in favor of unregistered offerings, such as those conducted in reliance on Rule 144A, because of the compliance burden of the existing rules. At the same time, a goal of the new rules is to continue to provide material information to investors regarding these structures in a more flexible format. It is worth noting that, in connection with the issuance of the rule proposal, Commissioner Kara M. Stein took the unusual step of issuing a separate public statement raising concerns about the proposed amendments.<sup>2</sup> In particular, Commissioner Stein noted that providing “increased flexibility” by allowing the removal of certain material information from audited financial statements could create a slippery slope and threaten the availability of high quality financial reporting to investors.

If approved as currently proposed, we believe that these amendments will encourage issuers of secured or guaranteed debt securities to engage in more SEC-registered debt offerings, particularly parent companies

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<sup>2</sup> See *Statement on Proposed Amendments to the Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize A Registrant's Securities (Rule 3-10 and Rule 3-16 of Regulation S-X)* (<https://www.sec.gov/news/public-statement/statement-stein-072418>).

that are already subject to Exchange Act reporting requirements and issuers that have recently completed acquisitions of companies that may not have the financial statements that are currently required.

In addition, as noted in our prior memorandum on this topic, these amendments should particularly benefit public companies that are organized as multiple-tier umbrella partnership structures, such as UP-Cs, UPREITs and UP-PTPs.<sup>3</sup>

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<sup>3</sup> For a fuller discussion on the impact of these amendments on multiple-tier umbrella partnership structures, please see our memo, [SEC Proposes Changes to Financial Disclosure Requirements That Will Enhance the Ability of Umbrella Partnerships to Issue SEC-Registered Debt](#).

For further information, please contact one of the following members of the Firm's Corporate Department.

WASHINGTON, D.C.

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**Joshua Ford Bonnie**

+1-202-636-5804  
[jbonnie@stblaw.com](mailto:jbonnie@stblaw.com)

**William R. Golden**

+1-202-636-5526  
[wgolden@stblaw.com](mailto:wgolden@stblaw.com)

NEW YORK CITY

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**Joseph H. Kaufman**

+1-212-455-2948  
[jkaufman@stblaw.com](mailto:jkaufman@stblaw.com)

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UNITED STATES

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New York  
425 Lexington Avenue  
New York, NY 10017  
+1-212-455-2000

Houston  
600 Travis Street, Suite 5400  
Houston, TX 77002  
+1-713-821-5650

Los Angeles  
1999 Avenue of the Stars  
Los Angeles, CA 90067  
+1-310-407-7500

Palo Alto  
2475 Hanover Street  
Palo Alto, CA 94304  
+1-650-251-5000

Washington, D.C.  
900 G Street, NW  
Washington, D.C. 20001  
+1-202-636-5500

EUROPE

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London  
CityPoint  
One Ropemaker Street  
London EC2Y 9HU  
England  
+44-(0)20-7275-6500

ASIA

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Beijing  
3901 China World Tower  
1 Jian Guo Men Wai Avenue  
Beijing 100004  
China  
+86-10-5965-2999

Hong Kong  
ICBC Tower  
3 Garden Road, Central  
Hong Kong  
+852-2514-7600

Seoul  
25th Floor, West Tower  
Mirae Asset Center 1  
26 Eulji-ro 5-Gil, Jung-Gu  
Seoul 100-210  
Korea  
+82-2-6030-3800

Tokyo  
Ark Hills Sengokuyama Mori Tower  
9-10, Roppongi 1-Chome  
Minato-Ku, Tokyo 106-0032  
Japan  
+81-3-5562-6200

SOUTH AMERICA

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São Paulo  
Av. Presidente Juscelino  
Kubitschek, 1455  
São Paulo, SP 04543-011  
Brazil  
+55-11-3546-1000