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SEC proposes changes to disclosures in certain registered debt offerings

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KPMG reports on the SEC's proposal¹ on disclosures for guarantors and issuers of guaranteed securities and affiliates whose securities collateralize issuers' securities.

Applicability

Companies with registered debt, or considering registered debt offerings or private debt offerings with registration rights.

Key facts and impacts

The SEC proposed changes to Rules 3-10 and 3-16 of Regulation S-X to simplify and streamline their disclosure requirements. The proposed rule² is part of the SEC's ongoing disclosure effectiveness project³ and intends to:

- focus disclosures on information that is material to the investor;
- make the disclosures easier to read;
- reduce compliance costs and administrative burdens;
- encourage potential issuers to conduct registered debt offerings or private offerings with registration rights; and
- improve transparency for market participants.

The proposed rule is expected to allow more issuers to provide alternative disclosures and reduce the number of required disclosures.

The SEC requested comments on the proposal, which are due 60 days after it is published in the Federal Register. Specifically, the SEC wants to know whether the proposed changes reduce the complexity and volume of disclosures while still providing investors appropriate information to make decisions.

Background

Guarantees of securities are considered securities that are subject to US securities laws and must be registered. Rule 3-10 addresses the financial statement requirements for the issuer and guarantor, and provides relief from some filing requirements when issuers and guarantors of guaranteed debt meet certain criteria.

Even though collateral agreements are not considered securities, Rule 3-16 requires issuers in certain circumstances to provide separate financial statements for each affiliate whose securities collateralize a registered security. Therefore, many issuers structure debt agreements to avoid triggering Rule 3-16.

¹ SEC Release No. 33-10526; 34-83701; File No. S7-19-18, Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, July 24, 2018

² The proposal relocates part of Rule 3-10 and all of Rule 3-16 to a new Article 13 in Regulation S-X, which would comprise proposed Rules 13-01 and 13-02.

³ SEC Disclosure Effectiveness project

What stays the same, and what changes?

The proposed rule still reflects the principle that the consolidated financial statements of the parent company and supplemental information about subsidiary issuers and guarantors is the primary source of information for investors to understand how the consolidated entities support the obligation.

Emphasis on materiality

The SEC expressed the view that current compliance efforts produce detailed information that is not useful to investors. To address this issue, the proposed rule introduces the application of a materiality assessment to assist issuers in determining what supplemental information they must present in the alternative disclosures. This would bring greater judgment into the disclosure process than what currently exists.

More subsidiaries can provide alternative disclosures

The proposed changes to Rule 3-10 would allow more subsidiaries to provide alternative disclosures because all consolidated subsidiaries would qualify instead of only those that are 100 percent owned. The proposed rule also would provide more definitions to ensure consistent application.

Reduced compliance costs

The SEC seeks to reduce compliance costs and increase the speed of reporting by introducing 'optionality of presentation'. Issuers may elect to exclude alternative disclosures from the notes to their financial statements, which would remove these disclosures from audit requirements and certain internal control over financial reporting considerations.

Financial statement requirements for Rule 3-10

Rule 3-10 requires that every issuer and guarantor of a registered security file separate financial statements. However, it allows exceptions when the issuer and guarantor structure matches one of five structures and meets certain conditions (e.g. the subsidiary or guarantor is 100 percent owned and each guarantee is full and unconditional).

The proposed rule would broaden the exceptions by allowing the subsidiary to be consolidated under consolidation guidance⁴ and the debt to be either fully and unconditionally guaranteed by the parent, or issued jointly and severally with the parent. This proposed change would create a parent-centric view of the guarantee, and is intended to simplify the eligibility criteria so that more issuers could use exceptions.

By taking the parent-centric approach, a subsidiary guarantee would no longer need to be full and unconditional. The proposal would clarify that the existence of subsidiary guarantee release provisions would not prevent a subsidiary guarantor from omitting its financial statements. However, the release disclosures would be provided only if they were material, and would be included with summarized financial information.

The requirement for one year of audited pre-acquisition financial statements of newly acquired issuers or guarantors would be eliminated because the SEC believes that existing requirements under Rule 3-05 provide sufficient information.⁵ However, if information is material to an investor, qualitative and quantitative information would be required to be disclosed.

Alternative disclosures

The SEC proposed changes to several aspects of the alternative disclosures, concentrating the disclosures on information that would be material to the investment decision of the registered security.

For example, nonfinancial disclosures would include:

- a description of the issuers and guarantors;
- the terms and conditions of the guarantees;
- how the issuer and guarantor structure and how other factors may affect payment to holders of the guaranteed securities; and
- any other quantitative and qualitative information considered material.

The tables outline proposed changes to other alternative disclosure requirements in Rules 3-10 and 3-16.

⁴ ASC 810, Consolidation, and IFRS 10, Consolidated Financial Statements

⁵ Regulation S-X, Rule 3-05

Current disclosure guidance for Rule 3-10	Proposed changes to alternative disclosures
Level of detail	
<ul style="list-style-type: none"> — Requires condensed consolidating financial information to include all major captions of the balance sheet, income statement and cash flows statement. — Requires additional financial and narrative information considered material to investors. 	<ul style="list-style-type: none"> — Eliminates the requirement for supplemental cash flows of the subsidiary issuer and guarantor. — Requires summarized financial information and any additional financial information considered material to investors (e.g. disclosure of related party revenues when a material amount of a guarantor’s revenues are derived from related party transactions with a non-guarantor subsidiary).
Combined basis	
<p>Requires columnar presentation of condensed consolidating financial information of the issuers, guarantors and non-guarantors</p>	<ul style="list-style-type: none"> — Allows presentation of summarized financial information of issuers and guarantors on a combined basis. — Removes the requirement to separately disclose financial information of non-guarantors. — Requires disclosure of the method the parent company selects to exclude non-issuers and non-guarantors from the combined summarized financial information (e.g. equity method of accounting for subsidiaries). — Requires separate summarized financial information of certain issuers and guarantors if the proposed nonfinancial disclosures apply to one or more, but not all, of the issuers and guarantors, if material. — Eliminates the requirement to reconcile the financial information included in the alternative disclosures to US GAAP when the financial statements are prepared on a comprehensive basis other than US GAAP or IFRS as issued by the IASB.
Periods presented	
<p>Requires condensed consolidating financial information as of, and for, the same periods included in the parent company’s consolidated financial statements.</p>	<p>Requires summarized financial information as of, and for, the most recently ended fiscal year and year-to-date interim period included in the parent company’s consolidated financial statements.</p>

Current disclosure guidance for Rule 3-10	Proposed changes to alternative disclosures
Location and audit requirement	
<ul style="list-style-type: none"> — Requires alternative disclosure to be included in the notes to the parent company’s consolidated financial statements. — Requires audited condensed consolidating financial information for the same periods as the parent company’s consolidated financial statements. 	<p>Requires proposed alternative disclosures to be:</p> <ul style="list-style-type: none"> — included in either: <ul style="list-style-type: none"> – the notes to the consolidated financial statements; or – MD&A (unaudited); — within: <ul style="list-style-type: none"> – a registration statement covering the offer and sale of the securities and any related prospectus; or – Exchange Act reports on Form 10-K, Form 20-F and Form 10-Q filed during the fiscal year in which the sale of the securities is completed; — included in the notes to the consolidated financial statements in Exchange Act reports on Form 10-K, Form 20-F and Form 10-Q beginning with the annual report filed for the fiscal year in which the sale of securities is complete; and — subject to annual audit, interim review and internal control over financial reporting requirements when included within the consolidated financial statements.
Reporting obligation	
<p>Requires alternative disclosures as long as the guaranteed securities are outstanding.</p>	<ul style="list-style-type: none"> — Requires proposed alternative disclosures as long as the issuers and guarantors have an Exchange Act reporting obligation. — Permits the parent company to stop providing proposed alternative disclosures if the corresponding subsidiary issuer’s or guarantor’s reporting obligation is automatically suspended by Section 15(d)(1) or through compliance with Rule 12h-3 of the Exchange Act. — Requires subsidiary issuer or guarantor to begin filing Exchange Act reports during the period it stopped meeting the proposed eligibility requirements.

Current disclosure guidance for Rule 3-16	Proposed changes to alternative disclosures
<ul style="list-style-type: none"> — Requires separate annual and interim financial statements for each affiliate whose securities constitute a ‘substantial portion’ of the collateral. — Requires audited financial statements of the affiliate for the same annual periods (and interim periods in a registration statement) as if it were a separate registrant. — Requires disclosure when the pledged securities meet or exceed a numerical threshold relative to the registered securities. 	<ul style="list-style-type: none"> — Requires financial and nonfinancial disclosures about the affiliates and collateral arrangement if material. — Permits summarized financial information on a combined basis for each affiliate whose securities are pledged as collateral and any additional items if material. — Requires disclosure as of, and for, the most recently ended fiscal year and interim period included in the issuer’s consolidated financial statements. — Specifies the location and audit requirements of the disclosures, which would be consistent with Rule 3-10’s proposed changes.

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