

# Defining Issues<sup>®</sup>

## SEC rules affect financial disclosures of certain registered debt instruments

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The SEC has adopted new rules on financial disclosure requirements<sup>1</sup> for guarantors and issuers of guaranteed securities and affiliates whose securities collateralize issuers' securities.

### Applicability

The new rules apply to:

- issuers and guarantors of registered debt, debt offerings being registered or private debt offerings with registration rights; and
- issuers and their affiliates whose securities are pledged as collateral for securities registered or being registered.

### Facts and impacts

The SEC finalized amendments to Rules 3-10 and 3-16 of Regulation S-X<sup>2</sup>. The final rule amends Rule 3-10 and partly relocates it to new Rule 13-01. Amended Rule 3-10 allows more issuers to provide certain financial and nonfinancial disclosures in lieu of separate audited financial statements if the revised eligibility conditions are met. Similarly, the requirements to provide separate audited financial statements in Rule 3-16 are replaced with those in new Rule 13-02. New Rules 13-01 and 13-02 specify the requirements of these disclosures, which consist of summarized financial information and qualitative information. They also permit companies to provide these disclosures either in an audited note to the financial statements or unaudited outside of the financial statements in management's discussion and analysis (MD&A).

As part of the SEC's ongoing disclosure effectiveness project,<sup>3</sup> the amendments aim to focus disclosures on material information to the investor, while making them simpler and reducing costs and burdens on companies. The SEC expressed its belief that the revised disclosures will encourage more issuers to conduct registered debt offerings or private offerings with registration rights. It stated that by reducing compliance burdens, and increasing the number of these structures, an environment for better investor protection may be created.

<sup>1</sup> SEC Release No. 33-10762; 34-88307; File No. S7-19-18, Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, March 2, 2020.

<sup>2</sup> SEC Proposed Rule, 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.

<sup>3</sup> SEC Disclosure Effectiveness project

## What stayed the same, and what changed?

Guarantees of securities are themselves considered securities subject to US securities laws and must either be registered or exempt from registration. These requirements create reporting obligations for guarantors and affiliates under existing securities laws. Existing Rule 3-10 permits reduced disclosures in certain limited circumstances, while existing Rule 3-16 does not provide any disclosure relief.

The final rule reflects an overarching principle that the consolidated financial statements of the parent company, and supplemental information about subsidiary issuers and guarantors, are the primary source of information for investors to make decisions. By creating a single set of eligibility criteria based on this principle, the amendments create and broaden disclosure exemptions relating to Rules 3-10 and 3-16.

### Financial statement requirements for Rule 3-10

The amendments allow parent companies who have filed their consolidated financial statements to provide financial and nonfinancial disclosures. Under new Rule 13-01, such disclosures may only be provided in lieu of full audited financial statements for any subsidiary issuer or guarantor consolidated in accordance with relevant GAAP, and where the guaranteed security is debt or debt-like<sup>4</sup> and is either (1) fully and unconditionally guaranteed by the parent, or (2) issued jointly and severally with the parent. This change aligns the rules with the overarching principle, and is intended to simplify the eligibility criteria so that more issuers can provide the financial and nonfinancial disclosures. The parent company must provide these disclosures any time subsidiary issuer or guarantor financial statements are omitted. In cases where a subsidiary guarantee is not full and unconditional, or where there are multiple guarantees that are not joint and several, the financial and nonfinancial disclosures will still be permitted, and disclosure of the terms and conditions are required.

#### KPMG observation

Amended Rule 3-10 permits parent companies to present summarized financial information of the parent company and each issuer and guarantor consolidated subsidiary on a combined basis. The combined financial information should eliminate intercompany transactions between issuers and guarantors and exclude subsidiaries that are not issuers or guarantors that the parent would otherwise consolidate. The final rule also took into consideration potential circumstances in which separate financial information about certain issuers and guarantors is material to an investment decision. Accordingly, when nonfinancial information provided in accordance with Rule 13-01 applies to one or more, but not all issuers and guarantors, separate disclosure of summarized financial information for that subsidiary is required, to the extent material. Nonfinancial information that could trigger separate disclosure includes factors that may affect payments to holders of the guaranteed security, such as contractual or statutory restrictions on dividends, guarantee enforceability or the rights of a noncontrolling interest holder.

The final rule also eliminates the requirement to provide one year of audited pre-acquisition financial statements of newly acquired issuers or guarantors. The SEC believes that existing requirements under Rule 3-05 provide sufficient information.<sup>5</sup> However, pre-acquisition summarized financial information will be required in certain registration statements and periodic reports when a parent company has acquired a significant business after the date of its most recent balance sheet, and that acquired business and/or one or more of its subsidiaries are obligated as issuers and/or guarantors. An acquired business will be deemed significant based on the same significance tests and thresholds included in Rule 3-05 of Regulation S-X.

<sup>4</sup> A guaranteed security is considered 'debt or debt-like' under the final rule if (1) the issuer has a contractual obligation to pay a fixed sum at a fixed time; and (2) where the obligation to make such payments is cumulative, a set amount of interest must be paid.

<sup>5</sup> Regulation S-X, Rule 3-05

## Financial statement requirements for Rule 3-16

Existing Rule 3-16 requires a registrant to provide separate audited financial statements for each affiliate whose securities constitute a 'substantial portion' of the collateral for any class of securities registered or being registered. There were no existing exemptions to this requirement and, therefore, many entities avoided entering into these structures or included language to remove the collateral from agreements when subjected to reporting requirements.

The final rule alters these requirements and allows a registrant to instead provide financial and nonfinancial disclosures about the affiliate(s) and the collateral arrangement as a supplement to the consolidated financial statements, unless they are not material to the holders of the collateralized security. These disclosures conform to the requirements of the new Rule 13-02. It additionally gives companies flexibility to provide the information in the notes to the financial statements on an audited basis, or outside the financial statements on an unaudited basis.

### KPMG observation

Registrants often structure debt agreements to release affiliate securities pledged as collateral if the disclosure requirements of existing Rule 3-16 are triggered. As a transitional matter, companies with registered securities that were issued and outstanding before January 4, 2021 and have collateral release provisions will continue to apply Rule 3-16 as they have historically and will not be subject to the disclosure requirements of Rule 13-02. In contrast, registrants with existing collateralized debt instruments that were not subject to such release provisions, as well as each registered security issued and outstanding after January 4, 2021, will provide the new disclosures required by Rule 13-02. Rule 13-02 will require registrants to provide financial and nonfinancial disclosures of the collateralizing affiliates rather than separate audited financial statements, which were required under Rule 3-16. The amendments are expected to reduce compliance burdens that have historically deterred registrants from these types of registered debt offerings.

## 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 amendments to Rules 3-10 require issuers to provide financial and nonfinancial disclosures to the extent they are material. The final rule includes four common scenarios to help issuers determine when financial disclosures may be omitted:

- 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; and
- 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.

Likewise, for disclosures required under Rule 3-16, new Rule 13-02 provides two scenarios when financial information about each affiliate may be omitted as it would not be material.<sup>6</sup> While the SEC believes these scenarios encompass most of the situations where financial information would not be material and may be omitted, a parent company can also make its own assessment based upon a consideration of other relevant

<sup>6</sup> The two scenarios include: (1) 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; and (2) the combined affiliates whose securities are pledged as collateral have no material assets, liabilities or results of operations.

facts and circumstances. If a parent company determines that not all of the required financial information is material, the information may be omitted without additional disclosure or explanation.

### Nonfinancial disclosures

The final rule changed several aspects of nonfinancial disclosures, concentrating the disclosures on information that would be material to the investment decision of the registered security.

Nonfinancial disclosures required by Rule 13-01 include:

- a description of the issuers and guarantors;
- the terms and conditions of the guarantees;
- how the issuer and guarantor structure, and other factors that may affect payment to holders of the guaranteed securities; and
- any other quantitative and qualitative information considered material to an investor and necessary to make the information presented not misleading.

Similarly, Rule 13-02 requires a description of:

- the securities pledged as collateral and the affiliates whose securities are pledged as collateral;
- the terms and conditions of the collateral arrangement, including the events or circumstances that would require delivery of the collateral; and
- the trading market for the affiliate’s security pledged as collateral or a statement that there is no market.

Additionally, when a nonfinancial disclosure applies to one or more, but not all, issuers and guarantors, a separate disclosure of summarized financial information for the issuers and guarantors to which the nonfinancial disclosure applies is required, to the extent it is material. A similar requirement exists when conditions apply to one or more but not all affiliates whose securities are pledged as collateral.

This table outlines the disclosure requirements in amended Rules 3-10 and 3-16 and new Rules 13-01 and 13-02.

Final amendments to Rule 3-10
<b>Financial information requirements</b>
<ul style="list-style-type: none"><li>— Requires summarized financial information, including select balance sheet and income statement line items, and an accompanying note describing the basis of presentation.</li><li>— Requires disclosure of any additional financial information considered material to investors (e.g. presentation of goodwill from non-current assets if substantially all of the obligated entities’ non-current assets consists of goodwill).</li><li>— Requires separate disclosure of an issuer’s or guarantor’s amounts due from, amounts due to, and transactions with non-obligated subsidiaries and related parties.</li><li>— Eliminates the requirement for supplemental cash flows of the subsidiary issuer and guarantor.</li></ul>
<b>Presentation requirements</b>
<ul style="list-style-type: none"><li>— Allows presentation of summarized financial information of issuers and guarantors on a combined basis.</li><li>— Requires intercompany transactions between issuers and guarantors presented on a combined basis to be eliminated.</li><li>— Removes the requirement to separately disclose financial information of non-guarantors.</li></ul>

## Final amendments to Rule 3-10

- Requires subsidiaries that are not issuers or guarantors to be excluded from the summarized financial information of the obligor group, even if an issuer or guarantor would otherwise be consolidated.
- Requires separate summarized financial information of certain issuers and guarantors if the 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

- Requires summarized financial information as of and for the most recently ended fiscal year and year-to-date interim period, if applicable, included in the parent company's consolidated financial statements.
- Requires the parent company to list each of its subsidiaries that is a guarantor, issuer, or co-issuer of guaranteed securities registered or being registered that the parent company issues, co-issues, or guarantees in new Exhibit 22.

## Location and audit requirement

Requires the alternative disclosures to be:

- included in either:
  - the notes to the consolidated financial statements; or
  - MD&A (unaudited)
- subject to annual audit, interim review and internal control over financial reporting requirements when included within the consolidated financial statements.

## Reporting obligation

- Requires alternative disclosures as long as the issuers and guarantors have an Exchange Act reporting obligation.
- Permits the parent company to stop providing alternative disclosures if the issuer's or guarantor's reporting obligation is automatically suspended.

## Recently acquired subsidiary issuers and guarantors

- Requires pre-acquisition summarized financial information when a parent company has acquired a significant 'business' after the date of its most recent balance sheet, and the acquired business and/or one or more of its subsidiaries are obligated as issuers and/or guarantors.

## Final amendments to Rule 3-16

### Financial information requirements

- Requires summarized financial information, including select balance sheet and income statement line items, and an accompanying note that describes the basis of presentation.
- Requires separate disclosure of an affiliate's amounts due from, amounts due to, and transactions with certain entities, to the extent material.
- Requires disclosure of any additional financial information considered material to investors.
- Requires nonfinancial disclosures about the affiliates and collateral arrangements if material.

### Presentation requirements

- Permits summarized financial information on a combined basis for each affiliate whose securities are pledged as collateral and any additional items if material.
- Requires intercompany transactions between issuers and guarantors presented on a combined basis to be eliminated.
- Requires separate summarized financial information if the nonfinancial disclosures apply to one or more, but not all, of the affiliates, if material.

### Periods presented

- Requires disclosure as of, and for, the most recently ended fiscal year and interim period included in the issuer's consolidated financial statements.

### Location and audit requirement

The location and audit requirements of the disclosures are consistent with amended Rule 3-10's final amendments.

### Recently acquired affiliates

Requires preacquisition summarized financial information when a registrant acquires a significant 'business' after the date of its most recent balance sheet, and the acquired business and/or one or more subsidiaries are affiliates whose securities are pledged as collateral.

## Effective dates and transition

### Issuers are required to comply with the final rule for:

- Securities Act or Exchange Act registration statements first filed on or after January 4, 2021
- Securities Act post-effective amendments filed on or after January 4, 2021 that include either the registrant's latest audited financial statements in the registration statement or an update to the prospectus

— Exchange Act periodic reports for periods ending after the effective date of a registration statement that was required to comply with the final amendments

— Exchange Act periodic reports filed on Form 10-K or Form 20-F for fiscal years ending after January 4, 2021, and Form 10-Q for quarterly periods ending after January 4, 2021

The transition periods also apply to filings of offerings relying on Regulation A as well as subsequent periodic reporting.

Earlier adoption is permitted at any time. If the amendments are early adopted, subsequent Exchange Act or Regulation A periodic reports must comply.

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