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)

Commissioner Kara M. Stein

Companies have a number of options to raise capital. Some raise capital through the sale of stock, some through the sale of debt, and others choose to do both. Even within these broad categories, there are numerous options. One method, for instance, is for a parent company to issue debt that is guaranteed by one or more of its subsidiaries. Another method is the flip of that—for the parent company to guarantee debt issued by one or more of its subsidiaries. Such arrangements can occur in the private markets or the public markets. When publicly issuing guaranteed debt, current Commission rules require a company to provide investors with detailed information about the nature and extent of the guarantees by requiring disclosure of both financial and non-financial information about the guaranteeing entities.[1]

This is like having a co-signer on a vehicle loan. The dealership providing the financing wants information about both the borrower and the co-signer because the likelihood of the loan getting repaid is dependent upon both of these parties. Like the dealership, investors in corporate debt need to understand the financial position of both the issuer and the guarantor in order to understand the likelihood of repayment.

In 2000, the Commission simplified its rules related to guaranteed debt, allowing companies to provide certain reduced financial information instead of what would otherwise be required under the federal securities law.[2] In particular, the 2000 amendments allowed companies to present condensed consolidating financial information rather than separate financial statements of the subsidiary guarantors.[3] Importantly, the amendments also reflected the central concern I noted above—that a full understanding of a guarantor's financial situation is necessary for an informed investment decision. Thus, in adopting the amendments, the Commission noted that the "staff's interpretations [from which the

amendments were drawn]…balance[d] the burden on issuers and guarantors *to disclose required information fully with the investor's need for information*."[4] Today, the Commission proposed additional amendments to these rules—rules 3-10[5] and 3-16[6] under Regulation S-X—to further reduce disclosure obligations. Unfortunately, I am not as confident that the proposal achieves quite the same balance.

The proposal centers on the idea that some of the current disclosures may not be necessary for investors. For example, the proposal notes that the Commission's current rules "require unnecessary detail, thereby shifting investor focus away" from important information. Reducing the information provided to investors on the basis that such information may be too much for investors to handle is a precarious road to walk down. [7]

Even more concerning is the proposal's attempt to provide "increased flexibility" by allowing certain material information[8] to be removed from the audited financial statements. I'm gravely concerned that the Commission is embarking on a slippery slope that might inadvertently result in threatening the strength and credibility of the bedrock of our markets—high quality financial reporting. Today's proposal provides companies with the "option" of providing material financial information to investors outside of the audited financial statements in order to accelerate when a company can raise capital. For years, investors have struggled to understand financial statements with alternative metrics that do not conform to agreed-upon standards, such as U.S. GAAP or IFRS, as supplements to their audited financial reports. In view of this, why is the Commission embarking down this path? The release states that it is intended to save costs, but does not provide adequate data in support. To move away from investor and market accountability, without having a full understanding of the reasons behind doing so, is troubling. Indeed, this type of argument can support the removal of virtually any single footnote currently required in the financial statements.[9]

Lastly, I am worried about the release's endorsement of private market disclosure practices as "best practices" for the public market. This too is a slippery slope. The Commission has long recognized that these two markets are separate and distinct for a reason. Investing in the private markets presents different risks for investors and far less transparency. That is why not all investors are permitted to participate in these markets. To look at the disclosure that is provided to a sophisticated investor and say that the same disclosure is sufficient for a retail investor simply does not make sense and runs contrary to the federal securities laws more broadly.

That being said, I think this proposal presents an important set of concerns for the public to weigh in on. The Chairman included many important questions about my concerns in the release, and I hope that investors, auditors, underwriters, and other market participants will provide us with thoughtful and robust comment on the myriad of issues that this release brings to the fore. In particular, should companies have a choice to take certain information out of audited footnotes and present it elsewhere in order to go to market faster? How does this benefit the investor? What are the costs? In the end, I supported today's proposal because I believe that it will allow the Commission to construct rules that could, ultimately, strike the right balance.

---

[1] Guarantees of securities are securities themselves for purposes of the Securities Act. As a result, the Securities Act requires the offering of both the guaranteed security and the guarantee itself to be either registered or exempt from registration. To the extent they are registered, a company in its registration statement must disclose both financial and non-financial information about the issuer of the guaranteed security as well as any guarantors.

[2] Financial Statements and Periodic Reports for Related Issuers and Guarantors, Securities Act Release No. 7878 (Aug. 4, 2000) [65 FR 51691 (Aug. 24, 2000)] (the "2000 Release").

[3] These alternative disclosures are permitted only if the subsidiary issuers or guarantors are 100% owned by the parent and the guarantees are full and unconditional. The amendments adopted in 2000 were, in effect, a codification of 17 years of staff interpretation of Staff Accounting Bulletin 53 in light of new and complex deal and guarantee structures. *See* Staff Accounting Bulletin Release No. 53 (June 13, 1983) [48 FR 28230 (Jun. 21, 1983)].

[4] *See* 2000 Release, at section I (emphasis added).

[5] 17 CFR 210.3-10.

[6] 17 CFR 210.3-16.

[7] *See* Letter from CalPERS dated November 15, 2015 (noting that the Commission's current rules are important in "evaluating the likelihood of payment by the issuer and guarantors").

[8] *See* Proposing Release, at section III.C.2.d. (noting that disclosures outside of the financial statements would "facilitate an analysis of the parts of the consolidated enterprise that are obligated to make payments as issuers or guarantors").

[9] While the proposal would allow a company the ability to provide certain financial information outside of the audited financial statements, I am encouraged that it would require that such disclosure be included in the footnotes to the parent company's consolidated financial statements for annual and quarterly reports beginning with the annual report for the fiscal year during which the first *bona fide* sale of the subject securities is completed.