November 1, 2018

Re: 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

via email: rule-comments@sec.gov

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Mr. Fields:

We are submitting this letter in response to the request by the Securities and Exchange Commission for comment on the proposed amendments to the Commission’s financial disclosure requirements applicable to guarantors and issuers of guaranteed securities in registered offerings, and to affiliates whose securities constitute a portion of the collateral securing a registrant’s securities in registered offerings, set forth in the above-captioned proposing release. We appreciate the opportunity to comment on the proposing release.

We support the Commission’s broad-based review of disclosure requirements and the presentation and delivery of disclosures under the Disclosure Effectiveness Initiative, of which the proposing release is a part, as well as the initiative by the Division of Corporation Finance to review the disclosure requirements applicable to public companies to consider ways to improve the requirements for the benefit of investors and public companies.

As a general matter, as set forth in our November 30, 2015 comment letter¹, we believe that, consistent with an effective public company disclosure regime that is grounded in providing material information to the reasonable investor, financial disclosure requirements for registered offerings of guaranteed debt securities and debt securities collateralized with securities of affiliates of the issuer should be guided by the following core principles:

¹ Available at https://www.sec.gov/comments/s7-20-15/s72015-16.pdf
• The disclosure requirements should ensure that material information needed by reasonable investors to make informed investment decisions is provided; and

• The anticipated benefits of any financial disclosure obligation should outweigh the associated costs.

We endorse the Commission’s endeavors to simplify the financial disclosure requirements for registered offerings of guaranteed debt securities and debt securities collateralized with securities of affiliates of the issuer, as reflected in the proposing release. We applaud the focus on easing the costs to registrants of complying with the disclosure requirements, while still providing investors with material information needed to make informed investment decisions. In particular, we support the overarching premise reflected in the proposing release that investors in such offerings generally rely on the consolidated financial information of the parent when making investment decisions.

We agree with the Commission’s view, reflected in the proposing release, that the proposed amendments will alleviate the costs and burdens of complying with Rules 3-10 and 3-16 of Regulation S-X, which have caused issuers to pursue alternatives to registered offerings in situations in which a subsidiary guarantee or a pledge of the securities of an affiliate as collateral are present, and should encourage these offerings to be conducted as SEC-registered offerings as a result.

In this letter, we offer some general observations regarding the proposed amendments and respond to certain questions raised by the Commission in the proposing release. In doing so, we identify our concerns and recommendations regarding the proposed amendments.

Proposed Amendments to Rule 3-10—Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered

As a general matter, we support the proposed amendments to Rule 3-10 included in the proposing release. As noted in our November 30, 2015 comment letter, we believe that the information currently required by Rule 3-10 is overly burdensome and is not material to an investment decision. Set forth below are our observations regarding certain of the proposed amendments to Rule 3-10.

1. Consolidated Subsidiary Condition

The proposing release includes a proposed amendment that would replace the condition that a subsidiary issuer or guarantor be 100% owned by the parent company in order to be eligible to omit its separate financial statements with a condition that the subsidiary issuer or guarantor be consolidated in the parent company’s consolidated financial statements. We believe that the current requirement is overly restrictive and therefore support the proposed amendment.

In our view, the goal of this condition is to provide investors with information on the creditworthiness of the subsidiary issuer or guarantor. However, we believe that, from a credit-risk perspective, as long as the parent company controls the subsidiary (a precondition to consolidation), there is no practical difference between a subsidiary that is 100% owned by the parent and one where third parties hold minority equity interests ranking subordinate to the debt obligation. Therefore, the inclusion of full financial information for a non-100% owned consolidated subsidiary increases the cost burden to the registrant without providing any material
incremental value to investors. As a result, we believe that the proposed amendment would reduce the registrant’s cost of complying with Rule 3-10 while ensuring that investors continue to receive sufficient information to make informed investment decisions.

2. Disclosure Requirements

We agree with the Commission’s proposal to replace the onerous requirement to provide condensed consolidating financial information with summarized financial information, as defined in Rule 1-02(bb)(1) of Regulation S-X, of subsidiary issuers and guarantors and the related proposal to allow such summarized financial information to be presented on a combined basis. The value to investors of a subsidiary guarantee is that the guarantee improves the investor’s claim on the assets of the subsidiary, which would otherwise be limited to the equity claim of the parent on such assets, and thus would be subordinated to claims of the subsidiary’s own creditors. Therefore, in addition to the consolidated financial statements of the parent, the key information required for an investment decision is information that allows investors to evaluate the extent of their structural subordination risk. We believe such information is limited to a metric of earnings of the non-guarantors as a single group, which the issuer should be able to choose, as well as the assets and liabilities of the non-guarantors as a single group. This is consistent with the information typically provided in Rule 144A offerings.

Although summarized financial information is still more detailed than what is typically included in Rule 144A offerings—and therefore more than knowledgeable investors believe is necessary to make informed investment decisions—we believe that the proposed amendments would alleviate much of the burden of complying with Rule 3-10. We also agree with the Commission that limiting the required summarized financial information to information for the most recent full fiscal year and interim period rather than the periods specified in Rule 3-01 and 3-02 of Regulation S-X would generally provide investors with sufficient information to make an investment decision. To the extent information about earlier fiscal years is nevertheless material to an investment decision, the liability provisions of the Securities Act of 1933 create powerful incentives for the provision of such information.

In addition to the requirement to provide summarized financial information, the proposed alternative disclosures set forth in the proposing release would require certain non-financial qualitative disclosures about the guarantees and the issuer and guarantors to the extent such disclosure would be material to investors in the guaranteed securities. We believe that the additional qualitative disclosure would impose less of a burden on registrants than the current requirements of Rule 3-10 and believe that such information, in certain circumstances, may be material to investors. However, the text of proposed Rule 13-01(a)(5) appears to add a general and broad requirement to provide “information that would be material to making an investment decision with respect to the guaranteed security.” This open-ended disclosure requirement could greatly add to the disclosure requirements to which a registrant is normally subject in its periodic reports, including with respect to information that is not specific to the guarantees. For example, the proposed rule could be interpreted to require that a registrant disclose a potential material acquisition in its periodic reports when it would not be required to do so if the proposed rule is not adopted. We do not believe that the Commission intended this result. Therefore, we recommend amending proposed Rule 13-05 to require that registrants disclose such further material information as is necessary to make the financial information presented not misleading, similar to text of current Rule 3-10(i)(11)(ii).
3. Location of Proposed Alternative Disclosures

We support the Commission’s proposal to allow registrants the flexibility to provide the summarized financial information, when required by Rule 3-10, either inside or outside the consolidated financial statements. This optionality would greatly reduce the cost of preparing the summarized financial information, as it would allow the information to be unaudited. In our experience, the current requirement that the alternative financial disclosures called for by Rule 3-10 be audited results in unregistered offerings of guaranteed debt securities, given the significant delays that the audit work poses to the timetables of these transactions.

The burden to the registrant posed by the costs of an audit outweigh the incremental benefit to investors of having the summarized financial information audited by the registrant’s independent auditor. In this regard, we note that the summarized financial information would be derived from the same internal accounting records used to prepare the audited consolidated financial statements and would be subject to the registrant’s disclosure controls and procedures, including required certifications. As a result, auditing the summarized financial information would provide little incremental value to investors while greatly increasing the registrant’s costs.

Notwithstanding the fact that the Commission’s proposal would allow registrants the flexibility to provide the required summarized financial information outside of the consolidated financial statements when engaged in a registered securities offering, proposed Rule 13-01(a) would retain the requirement after the offering is completed for registrants to include the summarized financial information in a footnote to their annual and quarterly reports, beginning with the annual report on Form 10-K for the year during which the first bona fide sale of the subject securities is completed. If adopted, this proposal would retain the burden that current Rule 3-10 places on registrants’ ongoing reporting subsequent to the offering of guaranteed securities, despite the Commission having made the judgment that including this information in the audited financial statements is not necessary for an investment decision. This is difficult to justify. If the information is not necessary for an investment decision, then it is not necessary for secondary market trading or portfolio monitoring, so requiring registrants nevertheless to provide it would impose an unjustifiable cost. We therefore recommend against adopting this proposed requirement.

4. Recently Acquired Subsidiary Issuers and Guarantors

We endorse the Commission’s proposal to remove the requirements of current Rule 3-10(g) to provide pre-acquisition financial statements of recently-acquired subsidiary issuers and guarantors. We agree with the Commission’s view that such pre-acquisition financial statements are burdensome and costly to preparers. As noted by the Commission, Rule 3-05 of Regulation S-X already requires pre-acquisition financial statements of significant acquired businesses. Additionally, proposed Rule 13-01 would require disclosure about any recently-acquired subsidiary issuer or guarantor to the extent material to an investment decision. Given these requirements, we see little benefit to an additional specified disclosure requirement with respect to recently acquired subsidiary issuers and guarantors.

5. Continuous Reporting Obligation

The proposing release includes a proposed amendment that would eliminate the requirement that a registrant provide the alternative financial disclosures set forth in current Rule 3-10 in its periodic reports for as long as the subject securities are outstanding. As a result, registrants
would be permitted to cease providing the information required by Rule 3-10 once their reporting obligations with respect to the subject securities are suspended by operation of Section 15(d)(1) of the Securities Exchange Act of 1934, or through compliance with Rule 12h-3 thereunder. This proposed amendment would bring the Commission’s rules into line with Congress’s clear intent to minimize the ongoing regulatory burden for unlisted securities, resolving an anomaly created by current Rule 3-10.

Proposed Amendments to Rule 3-16—Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered

The proposing release notes that the proposed amendments to Rule 3-16 are based on the principle that the most relevant information for an investment decision regarding a company’s securities is the company’s own consolidated financial statements. The Commission noted on p. 89 of the proposing release that “[t]he pledge of collateral is a residual equity interest that could potentially be foreclosed upon only in the event of default and almost always relates to an affiliate whose financial information is already included in the company’s consolidated financial statements.” Consequently, separate financial statements of an affiliate whose securities serve as collateral are not material in most situations. We support this overarching premise. Set forth below are our observations regarding certain of the proposed amendments to Rule 3-16.

1. Disclosure Requirements

Current Rule 3-16 requires full financial statements of an affiliate whenever the pledged securities of the affiliate constitute a “substantial portion” of the collateral. As we noted in our November 30, 2015 comment letter, this burdensome requirement often makes it uneconomical to secure publicly offered bonds with stock pledges. In our experience, registrants typically structure transactions specifically to avoid the application of Rule 3-16, by either avoiding pledges of subsidiary stock despite their possible usefulness or pursuing unregistered offerings where separate financial statements are not included. The fact that separate financial statements are not required by knowledgeable investors in unregistered offerings shows that such investors do not consider separate financial statements to be necessary to make informed investment decisions. For these reasons, we continue to believe that a requirement to provide separate financial information for an affiliate whose securities are pledged as collateral is unnecessary and should simply be eliminated.

Although the proposed amendments do not completely remove the obligation to provide financial information for such an affiliate, the proposed amendments do alleviate much of the burden of complying with current Rule 3-16 by replacing the requirement to provide separate financial statements with a requirement to provide summarized financial information for all such affiliates on a combined basis. As a result, we generally support the Commission’s proposal.

In addition to the requirement to provide summarized financial information, the proposed amendments would require certain non-financial qualitative disclosures about the affiliates and collateral arrangements. We believe this type of disclosure would be helpful to investors in making an investment decision with respect to secured debt securities. We note, however, that the text of proposed Rule 13-02(a)(5) raises the same concerns as those discussed above with respect to the text of proposed Rule 13-01(a)(5). Our comments set forth above also apply to this provision.
2. Location of the Required Disclosure

The proposed amendments to Rule 3-16 would allow registrants the flexibility to provide the required summarized financial information inside or outside the consolidated financial statements, similar to the approach taken with respect to summarized financial information required for subsidiary issuers and guarantors of guaranteed securities discussed above. For the reasons set forth above, we generally support this proposed amendment. However, as with the proposed amendments to Rule 3-10, in order to ensure that the requirements of proposed Rule 13-02 do not become overly burdensome for registrants, we recommend against adoption of the proposed requirement that the summarized financial information called for by proposed Rule 13-02 be included in a footnote to the registrant’s annual and quarterly reports beginning with the registrant’s annual report on Form 10-K for the year during which the first bona fide sale of the subject securities is completed.

3. “Substantial Portion” Test

The requirement to provide separate financial statements of an affiliate under current Rule 3-16 is triggered when the securities being pledged constitute a “substantial portion” of the collateral for the securities being registered. The current rule requires that the value of the pledged securities be compared to the outstanding principal amount of the securities being registered. The value of the pledged securities is deemed to be a “substantial portion” of the collateral if it exceeds 20% of the outstanding principal amount of the relevant securities. This test can result in the requirement to provide financial information in situations in which such disclosure is not helpful to investors. For example, the test would trigger a disclosure obligation where the value of pledged securities is immaterial when compared to the assets of a registrant but constitutes a “substantial portion” of the outstanding principal amount of the relevant securities because a large registrant has issued a small amount of securities. We believe that the Commission’s proposed revisions, which would eliminate the “substantial portion” test and require disclosure of the summarized financial information only when such information is material to holders of the collateralized security, is a more sensible approach. By focusing on materiality, new Rule 13-02 would only require registrants to undertake the expense of providing the required disclosure when doing so would be helpful to investors.

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We appreciate the opportunity to participate in this process and would be pleased to discuss our comments or any questions the Commission or its staff may have, which may be directed to Joseph A. Hall, Michael Kaplan, Byron B. Rooney, Richard D. Truesdell, Jr. or Pedro J. Bermeo of this firm at 212-450-4000.

Very truly yours,

Davis Polk & Wardwell LLP