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September 18, 2018

VIA EMAIL rule-comments@sec.gov
Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-19-18
Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities
Release No. 33-10526; 34-83701

Dear Mr. Fields:

We are grateful for the opportunity to present our views on the above-captioned release (the "Release") and the new rules it proposes. We commend the Securities and Exchange Commission (the "Commission") and its staff for tackling the complex and important issue of guarantor financial information and Rule 3-16 financial statements as part of its broader initiative on disclosure simplification and effectiveness. This letter respectfully submits our comments.

Executive Summary

We applaud the Commission's move to simplify the rules governing supplemental financial information for registered guaranteed debt securities and debt securities collateralized with pledges of securities of affiliates. We believe the proposed rules represent a thorough and thoughtful effort to ease the burden on registrants while still providing investors with material information. Except as noted below, we generally support the proposed revisions to Rule 3-10 and Rule 3-16 outlined in the Release.

In particular, we agree with the Commission's premise that investors in guaranteed debt securities that provide recourse against the parent company of a corporate group rely primarily on the parent company's consolidated financial statements. Most of our comments respond to the questions raised in the Release regarding the supplemental information about a parent company's subsidiaries that investors need to make an informed investment decision with respect to guaranteed debt securities.

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In terms of the practical impact of the proposed revisions, we believe they will be primarily relevant in two areas: investment grade companies that have debt at subsidiaries, often as the result of acquisitions, and the slowly shrinking number of high-yield issuers that use the registered market. We are skeptical about the prospect that the proposed revisions will bring high-yield issuers that have migrated to the "Rule 144A for life" market back to the registered market to a meaningful extent. It is our impression that for high-yield debt securities the growth in the size and depth of the Rule 144A for life market has largely eliminated the historical pricing benefits of registered issuance.

Our substantive comments and suggestions relate to the following five areas, and we discuss each of these in more detail in the remainder of this letter:

- ***Default Risk, Structural Subordination and Materiality***. With respect to subsidiary guarantees, the revised rules follow the theory that every subsidiary guarantor is an issuer, every subsidiary guarantee is a security, and what therefore must matter to investors is the financial ability of subsidiary guarantors to make payment under the guarantee. We respectfully submit that this framework is not useful for evaluating the materiality of supplemental financial information about subsidiary guarantors. It leads to some disclosures that are unlikely to be relevant, while omitting others that are important. We believe that investors evaluate default risk based on the consolidated financial statements. Subsidiary guarantees affect not the risk of default, but the effective ranking of the securities, and therefore investors' recovery, in the event of default. Supplemental financial information for subsidiary guarantees should focus on structural subordination.

- ***Modifications to Summarized Financial Information***. A materiality lens that focuses on structural subordination would have consequences for determining what financial information is likely to be material to investors in guaranteed debt securities. The two most significant implications would be to require disclosure about the amount of third-party indebtedness and other liabilities of non-obligor entities and to use operating income rather than income from continuing operations or net income as the profitability metric in summarized financial information.

- ***Materiality of Summarized Financial Information***. The Release indicates that the Commission presumes the proposed summarized financial information to be material for an informed investment decision with respect to guaranteed debt securities and may interpret the proposed materiality exception narrowly. We suggest clarifying that materiality determinations in exempt offerings remain unaffected by the materiality presumption and that in the registered context registrants are able to consider a multitude of factors in assessing to what extent the summarized financial information is material.

- ***Open-Ended Duty to Disclose All Material Information***. Deviating from standard principles, the proposed rules appear to contain an open-ended duty to disclose all information that would be material for an investment decision. As written, this could require the disclosure of pending merger negotiations and other strategic transactions in

periodic reports. We do not believe that the Commission intended this result, and we recommend that the relevant provision be revised.

- ***Intercreditor Consequences of Rule 3-16 Repeal***. Due to customary cutback provisions, the proposed repeal of Rule 3-16 and its replacement with required disclosure of summarized financial information could result in the immediate reallocation of substantial collateral value among different creditor classes of affected registrants upon effectiveness of the new rules. We would like to ensure that the Commission is aware of these intercreditor consequences when deciding whether the proposed repeal should be limited to new issues or also apply to outstanding collateralized debt securities.

Default Risk, Structural Subordination and Materiality

In the Release, the Commission is asking some very fundamental questions about debt financing structures involving guaranteed securities, including why issuers include guarantees. We believe these are the right questions to ask and that answering them will help guide the path to disclosure that is useful to investors.

The Commission's framework for analyzing what supplemental financial information would be material for informed investment decisions with respect to guaranteed debt securities appears to be the risk of default. As stated in the Release, the Commission believes that investors care primarily about "whether payment will be made in full on the dates specified in the guaranteed security"[1] and therefore intends the revised rules to facilitate an investor's evaluation of whether the obligor entities have the ability, including the assets, to make those payments as required.[2]

While we agree that default risk is very material for an investment decision with respect to all types of debt securities, we struggle to see how subsidiary guarantees can have any meaningful impact on the probability of default, or how financial information of subsidiary guarantors can help in assessing it. We believe that investors evaluate default risk primarily based on the group's consolidated financial condition as reflected in the consolidated financial statements. Once the parent company issuer has failed to pay any amount when due, subsidiary guarantors provide no realistic alternative source of payment. Not only is their economic fate closely correlated with that of the parent company, but the very existence of the subsidiary guarantee will make it a virtual certainty that when the parent company seeks bankruptcy protection, the subsidiary guarantors will too. More importantly, subsidiaries do not own any assets to which parent company creditors do not already have recourse through the parent's equity ownership.[3]

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[1] Release at 59.

[2] Release at 63 (supplemental information "would help facilitate an investor's evaluation of whether the entities in the Obligor Group have the ability to make payments as required under the guaranteed security, including what assets are available to satisfy those obligations").

[3] The existence of minority interests in the subsidiary does not affect the composition of the asset pool, but only the portion of that pool to which the parent company, and therefore its creditors, are entitled.

Subsidiary guarantees of parent company debt are best understood not as a means for reducing the risk of default or providing recourse to an *additional* asset pool in the event of a default, but as a way to improve the effective ranking of claims against the *same* asset pool if and when a default occurs.[4] Parent guarantees of subsidiary debt are different because they do in fact increase the asset pool to which creditors have recourse. Once debt securities of a subsidiary issuer have been guaranteed by the parent company, guarantees from other subsidiaries of the parent company that are not also subsidiaries of the issuer are analogous to subsidiary guarantees in that they do not provide recourse to additional assets.

The effective ranking impact of subsidiary guarantees is the result of the "asset partitioning" associated with legal entities. As a matter of general corporate and bankruptcy law, a person's creditors' claims on assets held through a separate legal entity will effectively be subordinated to the claims of the creditors of that entity.[5] This is because the equity owner of a legal entity has only a residual claim on the entity's assets, after all of the entity's creditors have been paid off. Creditors of the equity owner are in no better position. This effect is referred to as structural subordination. For example, nonguaranteed debt of a parent company is "structurally subordinated" to debt and other liabilities of that parent company's subsidiaries to the extent of the value of the assets of those subsidiaries. The purpose of subsidiary guarantees is to protect against this structural subordination. They do this by giving parent company creditors direct claims against the subsidiary guarantors that rank equally with the claims of the subsidiary guarantors' other creditors. Conversely, debt of a parent company that benefits from subsidiary guarantees is said to be "structurally senior" to other debt of the parent company that does not have those guarantees.[6]

From an effective ranking perspective, subsidiary guarantees are similar to asset pledges because they give one group of creditors a prior claim on certain assets together with a pro rata claim to other assets, all ultimately owned by the same equity owners.[7] For asset pledges, Regulation S-X requires only basic information about the assets being pledged and the secured obligations, but no supplemental financial information, unless the pledge relates to affiliate securities and triggers the application of Rule 3-16.[8]

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[4] The most comprehensive study is Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. Chi. L. Rev. 605 (2011) (describing the use of intra-group guarantees as a way to improve the recovery of guaranteed creditors in an insolvency at the expense of nonguaranteed creditors).

[5] Henry Hansmann and Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L. J. 387, 409 (2000).

[6] *See*, *e.g.*, *In re Owens Corning*, 419 F. 3d 195, 212-13 (3d Cir. 2005) (discussing concept of structural seniority conferred by subsidiary guarantees).

[7] *See*, *e.g.*, Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 Yale L. J. 806, 812-13 (2009) (describing similarities between secured debt and debt with intra-group guarantees).

[8] Rule 4-08(b) of Regulation S-X (requiring assets mortgaged, pledged, or otherwise subject to lien, and the approximate amounts thereof, to be designated and the obligations collateralized to be briefly identified).

We respectfully propose that, in the final release, the Commission consider endorsing structural subordination as the appropriate framework for analyzing the materiality of supplemental financial information to be provided to investors in guaranteed debt securities in addition to the consolidated financial statements.[9] We recognize that such a shift in perspective would represent a departure from the way the Commission and its staff have historically framed the policy question of required guarantor financial information. However, we believe that it would result in an improved analysis of materiality and disclosure questions in this area, which would benefit both issuers and investors.

Modifications to Summarized Financial Information

Adopting structural subordination as the appropriate materiality lens would have consequences for the type of financial information the rules about guaranteed debt securities should require. That information would not focus on default risk and the ability of subsidiary guarantors to make payment when due. Instead, the rules would provide investors with information that enables them to evaluate the extent of structural subordination, which would imply changes to the proposed summarized financial information. The following two seem most important.

First, the rules should require the disclosure of certain financial information about non-guarantor subsidiaries, specifically the amount of debt and other liabilities at those entities, rather than treating non-guarantor financial information as unlikely to be material.[10] It is precisely to those liabilities that the guaranteed debt securities will be structurally subordinated, with third-party debt being more relevant than ordinary course trade payables.[11] Financial information about the liabilities of the obligors, in contrast, is likely to be less material, because all of those liabilities will be reflected in the consolidated financial statements and will rank structurally alongside the guaranteed debt securities. The amount of those liabilities that are secured, and therefore effectively senior to unsecured debt securities, could be relevant, but sufficient information about that should already exist in the notes to the consolidated financial statements.[12]

Second, any profitability metrics about the obligors (or non-obligors) should be capital structure-neutral by excluding interest expense. In a default, the levered equity value of the obligors is

[9] The Release contains brief references to the concept of structural subordination in a footnote (*id*. at 13 n.33) and in the economic analysis (*id*. at 119) but does not discuss its disclosure implications.

[10] *See* Release at 60 (separate supplemental financial information of non-guarantor subsidiaries is not likely to be material to an investment decision because non-guarantor subsidiaries are not obligated to make payments).

[11] Trade creditors may not enjoy priority as a matter of law, but they may have to be paid in full in order to preserve the business as a going concern. *See* Brad B. Erens and Timothy W. Hoffmann, *The Triumph of Trade Creditors in Chapter 11 Reorganizations*, 9 Pratt's J. Bankr. L. 3 (2013) (describing how trade creditors are often paid in full or at a higher rate than other unsecured creditors as part of a reorganization or a sale under section 363 of the Bankruptcy Code).

[12] Rule 4-08(b).

irrelevant, because the capital structure will be readjusted through a reorganization or liquidation. What matters to creditors in that scenario is what portion of the consolidated enterprise value is represented by the obligors compared to the non-obligors, and differences in profitability between the two groups can be relevant for that analysis. This is consistent with disclosure practices in the Rule 144A high-yield bond market. To the extent offering documents for those transactions include supplemental profitability information about the obligors or non-obligors, it is generally presented on the basis of operating income or EBITDA, each excluding interest expense. In contrast, the profitability metrics in the proposed summarized financial information would consist of income from continuing operations and net income, both of which are skewed by the allocation of interest expense within the corporate group under the pre-default capital structure.

Materiality of Summarized Financial Information

Unlike the original Rule 3-10 adopting release,[13] the Release is replete with statements regarding the presumed materiality of the proposed summarized financial information for an informed investment decision.[14] We do not believe that the Commission intended to change disclosure practices in the Rule 144A market, but most of these statements are not expressly limited to registered offerings. It would be helpful if the final release could clarify that the materiality presumption has no bearing on materiality determinations in exempt offerings.

In addition, although the proposed rules contain an overriding materiality exception, reliance on that exception may prove difficult in practice if the Commission takes a narrow view of its scope. Other than a finance subsidiary, the Release offers only a single example of a situation where the exception would be available: when there are no material differences between the proposed summarized financial information and the consolidated financial statements.[15] It would be helpful if the Commission could make it clear that this one-item list is not intended to limit the factors that registrants will be able to consider. Among other things, Commission rules and market practice for comparable structures can be useful guideposts for determining materiality.

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[13] Release No. 33-7878; 34-43124 (August 4, 2000).

[14] *E.g.*, Release at 54 (“material information needed to make an informed investment decision”), *id*. (“material information . . . that we believe investors in registered offerings need to make informed investment decisions about guaranteed debt securities”), *id*. (“material information investors need”), 56 (“information that is most likely to be material to an investment decision”), 65 (“proposed requirements are composed of items we believe are most likely to be material to an investor”) and 67 (“we believe investors should receive all disclosures specified in the proposed rule, unless such information is immaterial”).

[15] Release at 67 n.151 and accompanying text.

For example, others have noted that the materiality of supplemental financial information in relation to subsidiary guarantees is a function of the likelihood of default.[16] As discussed above, the presence or absence of subsidiary guarantees does not impact the probability that an issuer will default on its debt securities. They merely affect the effective ranking of the debt securities, and therefore the amount of any recovery, if and when a default occurs. Consequently, the less risky an issuer's credit, the less relevant is information about structural subordination.

This risk-weighted perspective is consistent with the Commission's rules and long-standing market practice for debt securities issued by parent companies without subsidiary guarantees. The absence of subsidiary guarantees means that those debt securities are structurally subordinated to debt and other liabilities of subsidiaries to the extent of the asset value of the subsidiaries. Nevertheless, the Commission's rules do not require, and offering documents generally do not contain, unconsolidated financial information for the parent company as the sole obligor in these transactions.[17] The lack of disclosure has to do with the market's view regarding the credit quality of the relevant issuers. Debt issuance structures without subsidiary guarantees are standard in the investment grade market, where default probabilities are lower, and detailed information about effective ranking and recovery in a default is therefore less relevant. Depending on the circumstances, issuers may include basic information about the amount of debt or other liabilities at subsidiaries in that case.

Open-Ended Duty to Disclose All Material Information

It is a bedrock principle of the federal securities laws that there is no open-ended duty to disclose everything that an investor would consider material in making its investment decision.[18] Instead, the statutes enacted by Congress and the Commission's forms, rules and regulations contain specific and detailed disclosure requirements. These line item disclosure requirements are supplemented by the obligation to disclose any additional material information that may be

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[16] Comment letter of PricewaterhouseCoopers LLP dated November 30, 2015 on Release Nos. 33-9929, 34-75985, IC-31849; File No. S7-20-15 at A11 (recommending that the Commission consider whether extensive disclosure is necessary for an event that would be viewed as remote).

[17] An exception applies if more than 25% of the consolidated net assets are held by subsidiaries and subject to restrictions that make them unavailable for distribution or other transfer to the parent company without third-party consent. Rules 5-04(a)(3), 7-05(a)(3) and 9-06 of Regulation S-X (requiring condensed parent company stand-alone financial information pursuant to Rule 12-04 of Regulation S-X). Even this disclosure does not focus on structural subordination, but on parent company liquidity.

[18] *See*, *e.g.*, *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) ("But a corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts."), citing *Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("To be actionable, of course, a statement must also be misleading. Silence, absent a duty to disclose, is not misleading under Rule 10b-5.").

necessary to make the required statements not misleading.[19] And any disclosure must not omit to state a material fact necessary to make the statements made not misleading.[20]

One of the areas where this principle is particularly relevant is the disclosure of pending merger negotiations. While registration statements may require the disclosure of significant acquisitions or dispositions that are merely probable, this is based on specific numerical thresholds, and no such disclosure is required in periodic reports.[21] The Commission has also issued interpretive guidance that the disclosure of pending merger negotiations is not triggered by the obligation to discuss known trends and uncertainties in MD&A.[22] At the same time, it is settled law that even preliminary merger discussions can be material, depending on the circumstances.[23]

The existing rules regarding guarantor financial information respect the principle that there is no open-ended duty to disclose all material information that may exist at any given time. In addition to the specified consolidating financial information, Rule 3-10 currently requires the disclosure of further information only to the extent it would be material for investors to evaluate the sufficiency of the guarantee or so as to make the financial information presented not misleading.[24]

In contrast, new Rule 13-01(a)(5) would require the disclosure of "[a]ny other quantitative or qualitative information that would be material to making an investment decision with respect to the guaranteed security."[25] On its face, this requirement is extremely broad and not limited to information specific to the guarantees. Indeed, it could be read to mandate the disclosure in the parent company's periodic reports of pending merger negotiations or other potential transactions that may affect the value of the guaranteed debt securities if implemented, such as debt refinancing or restructuring transactions, among other matters. In addition to creating litigation risk, such an open-ended disclosure duty would set a problematic precedent for future rule-making by the Commission in other areas. It may also be somewhat at odds with the legislative choice to proscribe the omission of material facts not generally, but only to the extent they are required to be stated or otherwise necessary to make the statements made not misleading.[26]

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[19] Rule 408(a) under the Securities Act of 1933, as amended (the "Securities Act") and Rule 12b-20 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"); Rule 4-01(a) of Regulation S-X.

[20] Securities Act Sections 11(a), 12(a)(2), 17(a)(2); Exchange Act Section 10(b), Rule 10b-5(b) thereunder.

[21] Rule 3-05 of Regulation S-X.

[22] Release No. 33-6835; 34-26831 (May 18, 1989), part III.F.4 (discussing Item 303 of Regulation S-K).

[23] *Basic v. Levinson*, 485 U.S. 224 (1988).

[24] Rule 3-10(i)(11)(i) and (ii).

[25] A similar provision has been proposed with respect to collateralized debt securities in new Rule 13-02(a)(5). Our comments apply also to that provision.

[26] Securities Act Sections 11(a) and 12(a)(2). *See also* Exchange Act Sections 10(b) and 18(a).

We do not believe that the Commission intended to introduce a new open-ended disclosure duty applicable just to guaranteed debt securities, or for general disclosure standards to vary based on the presence or absence of guarantees. Instead, we assume that the Commission only wanted to ensure that disclosures in relation to guaranteed debt securities would include such additional information as would be material for evaluating the guarantees. A rule that would require registrants to disclose such further material information as is necessary to make the financial information presented not misleading seems sufficient to achieve that result. We therefore recommend that the Commission revise proposed Rule 13-01(a)(5) in the final release accordingly. Alternatively, the Commission could consider expressly requiring the disclosure of further information that would be material for investors to evaluate the sufficiency of the guarantee, as currently mandated by Rule 3-10, or perhaps the guarantee structure.

Intercreditor Consequences of Rule 3-16 Repeal

Existing Rule 3-16 requires separate financial statements of each affiliate whose securities constitute a substantial portion of the collateral for registered secured debt securities. The proposed revisions would repeal Rule 3-16 and replace it with a requirement to disclose summarized financial information of the affiliates whose securities are pledged as collateral, to the extent material.

As the Commission notes in the Release, registered collateralized debt securities are often structured to avoid Rule 3-16 disclosures by including clauses that reduce the amount of affiliate securities pledged as collateral just below the amount that would trigger the requirement for separate financial statements under Rule 3-16. Commonly referred to as "3-16 cutback provisions," these clauses rely on Rule 3-16's numerical threshold that is reached when the aggregate principal amount, par value, book value or market value of the pledged affiliate securities, whichever is the greatest, equals 20 percent or more of the principal amount of the class of collateralized debt securities. Offering documents in these transactions explain how the cutback provision operates, and we believe investors in companies with collateralized debt securities that are subject to a cutback provision understand its implications.

Cutback provisions affect not just holders of the relevant collateralized debt securities, but also holders of other collateralized debt that is secured by the same collateral but not subject to the cutback provision—principally bank loans. In addition, cutback provisions carry significance for unsecured creditors. By reducing the amount of collateral, cutback provisions increase the amount of the issuer's unencumbered assets and thus the recovery on unsecured claims.

As currently proposed, the repeal and replacement of Rule 3-16 would apply not only to new registered collateralized debt securities, but also to series that are currently outstanding. The impact on any given series will depend on the precise wording of the applicable cutback provision, and two outcomes are possible:

- Some cutback provisions may be clear that they are only implicated by full separate financial statements of the relevant affiliate, but not by the type of summarized financial information contemplated by proposed Rule 13-02. In that case, the cutback provision

would cease to apply upon the effectiveness of the repeal, thereby immediately and potentially substantially increasing the amount of collateral securing the relevant series of debt securities. This increase would necessarily come at the expense of any other creditors sharing in the same collateral but not subject to a 3-16 cutback provision as well as of unsecured creditors. It would thus transfer significant collateral value from secured bank lenders and unsecured creditors to secured bondholders.

- Other cutback provisions may be less clearly worded, and there could be ambiguity as to whether they continue to apply if the required financial information about the issuers of the pledged securities consists only of summarized financial information, rather than full separate financial statements. Such ambiguity could make it difficult to determine the amount of collateral actually pledged, especially with the proposed materiality exception.

The Commission will decide whether to make the proposed repeal and replacement of Rule 3-16 applicable not just to new issues, but also to currently outstanding series. We respectfully submit that, in making this decision, the Commission should consider not just the easing of the reporting burden on issuers, but also the decision's potentially significant monetary implications for existing secured and unsecured creditors.

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We hope the Commission and its staff find our comments useful in further considering the proposed revisions and formulating the final rules. If there are any questions about any of our comments, we would welcome an opportunity for further discussion. Please do not hesitate to contact Harald Halbhuber, Kyungwon Lee or Lona Nallengara of this firm at 212-848-4000.

Yours sincerely,

Shearman & Sterling LLP