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November 30, 2015

Re: **Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant**
Release No. 33-9929; 34-75985; IC-31849; File No. S7-20-15

VIA E-MAIL: rule-comments@sec.gov

Mr. Robert W. Errett
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Mr. Errett:

We are submitting this letter in response to the request by the Securities and Exchange Commission (the "**Commission**") for comment on the effectiveness of financial disclosures for certain entities other than a registrant (Release No. 33-9929; 34-75985; IC-31849; File No. S7-20-15) dated September 25, 2015 (the "**Release**"). We appreciate the opportunity to comment on the Release and the important issues it raises.

We support the Commission's broad-based review of the disclosure requirements and the presentation and delivery of the disclosures under the Disclosure Effectiveness Initiative, 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. The Disclosure Effectiveness Initiative should work toward the dual goals of streamlining disclosure requirements while improving the clarity, relevance and usability of disclosure for investors.

This letter identifies our concerns and recommendations in two parts. First, the letter covers these considerations on a general level with respect to the overarching policy and efficiency concerns relating to the current financial disclosure requirements in Regulation S-X for certain entities other than a registrant (referred to herein as "**third parties**"). Second, this letter covers

these considerations specifically with respect to each of Rules 3-05[1], 3-09[2], 3-10[3] and 3-16[4] of Regulation S-X. We describe these issues in greater detail below.

General Considerations Regarding the Effectiveness of Financial Disclosures About Entities Other Than the Registrant

As a general matter we believe that, consistent with an effective public company disclosure regime that is grounded in providing material information to the reasonable investor, any proposed changes to the current financial disclosure requirements in Regulation S-X for third parties should be guided by the following core principles:

- Any mandated changes to the current financial disclosure requirements in Regulation S-X for third parties must be designed so that material information needed by reasonable investors to make informed investment and voting decisions is provided; and

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

In our view, there are a number of possible revisions to the current financial disclosure requirements in Regulation S-X for third parties set forth in the Release, including reducing the number of instances where separate financial statements are required and in certain cases allowing more reliance on summarized and condensed financial information, that would satisfy these concerns. These revisions could take various forms, such as changes or alternatives to the significance tests, revisions to the financial measures used to determine significance or revisions to the bright-line thresholds, or providing registrants with the ability to apply additional judgment in determining significance, all of which could enhance the information provided to investors and promote efficiency, competition and capital formation. Providing registrants with the ability to apply additional judgment in preparation of separate financial statements as opposed to imposing rigid bright-line rules would have the result of providing more tailored and relevant disclosure.

1. **Experience Indicates that Information Disclosed Pursuant to the Current Financial Disclosure Requirements in Regulation S-X for Certain Entities Other Than a Registrant Is Not Material.**

As an initial matter, we believe that skepticism is warranted as to whether financial statements for third parties are needed or even desired by the investment community at all. We are concerned that the requirement to provide these financial statements does not appear to be based on any empirical evidence that investors actually find these financial statements useful or rely on them for making investment decisions.[5] Whether there is even market demand for this information

[1] 17 CFR 210.3-05.

[2] 17 CFR 210.3-09.

[3] 17 CFR 210.3-10.

[4] 17 CFR 210.3-16.

[5] The concept of materiality is central to issuers' disclosure obligations under the federal securities laws. The general rule for determining the materiality of particular information is whether there is a substantial likelihood that a reasonable investor would have considered the information important in making her investment or voting decision. "Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

remains a question that the Commission has never sought to answer, but we believe the market has answered negatively.

Importantly, our experience is that market participants in unregistered, Rule 144A offerings—initial purchasers as well as institutional investors—do not ever request or require that the prescribed financial statements (other than Rule 3-05 financial statements, which are commonly included) be included in the offering document for such an unregistered offering, which suggests that the offering participants do not believe this information is relevant for investors and that investors do not consider the information to be material or to provide useful and meaningful information to them when making an ultimate investment decision. Our firm is one of the leading participants in the capital markets, and particularly in the Rule 144A market, and we are not aware of a single Rule 144A offering that has ever included Rule 3-09, 3-10 or 3-16 financial statements that were not otherwise already available. Underwriters, counsel and investors do not require these financial statements or view them as useful.

While Rule 144A offerings do often include Rule 3-05 financial statements, in our experience issuers, underwriters, counsel and investors are more willing to omit this information even when the Commission would require it. More importantly, the Commission permits these financial statements to be provided 75 days after closing of a transaction (in the absence of an offering), and billions of dollars of securities trade during the time from deal announcement until that time without this information. In most instances, securities do not trade differently upon the filing of the required Form 8-K, suggesting that this information is less material than one might think.

In keeping with a materiality-centered, principles-based disclosure framework, we believe the Commission should consider amending Rule 3-05 of Regulation S-X to permit registrants to omit the currently required financial statements so long as the effect of omitting the information would not be misleading and the omission of such financial statements would not render the registrant's financial statements substantially incomplete or misleading. Some latitude should be provided for such a principles-based materiality analysis. A principles-based approach will elicit more relevant and useful information than a strictly rule-based framework because it will provide more flexibility for issuers to use their judgment in disclosing information that they believe is material to investors depending on facts and circumstances unique to each registrant. Alternatively, the thresholds of significance should be modified to only capture larger transactions. With respect to Rules 3-09, 3-10 and 3-16, we believe that Rule 3-09 and Rule 3-16 should simply be deleted, and Rule 3-10 should only require limited quantitative disclosure of the amount of revenue, earnings (using a metric deemed relevant by the issuer), assets and liabilities held by non-guarantors, which is consistent with practice in unregistered deals.

2. Information Disclosed Pursuant to the Current Financial Disclosure Requirements in Regulation S-X for Certain Entities Other Than a Registrant Does Not Provide Adequate Benefits to Investors Relative to the Costs to Public Reporting Companies.

We have no doubt, however, that when the question is put to investors broadly, some will respond that they would indeed like the financial statements discussed in the Release and currently required under Regulation S-X. We would ask the Commission to bear in mind that there is no cost to investors of receiving this information. While we cannot exclude the possibility that there may in fact be an investor or group of investors who would actually find this information useful, the materiality inquiry is not based on the particular information preferences of a subset of

investors, but on what a “reasonable investor” needs for decision-making purposes. As it is the market practice for the full spectrum of unregistered debt offerings to exclude certain financial statements required under Regulation S-X for third parties, it is hard to conclude that this information is indeed needed by a “reasonable investor” for their decision-making purposes. Also, there is a cost to the current requirements—both the cost of preparation, as well as the loss of investor protection that results when issuers opt to issue under Rule 144A to avoid compliance with these requirements. In fact, many debt offerings are now “144A for life” specifically to avoid the need for compliance with Rules 3-10 and 3-16.

We believe disclosure requirements must evolve over time and it is important that they do so in a manner that retains the focus on information that provides a benefit to investors that is commensurate with the resulting compliance costs to issuers. The benefit to investors should be analyzed from the viewpoint of what is material to a reasonable investor’s ability to understand and evaluate a business, as noted above. Disclosures should help investors make better-informed investment and voting decisions. Further, investor informational benefits should be appropriately balanced against compliance costs and burdens on public reporting companies and the potential impact on efficiency, competition and capital formation.

There is no clear evidence that the Commission’s goals of investor protection and fulsome disclosure are achieved by the current requirements to provide financial statements of third parties mandated by Regulation S-X. We do not believe many of these financial statements help investors make better-informed investment and voting decisions, improve the quality of financial analysis or otherwise deliver significant value for investors. However, these requirements often result in increased burdens and costs on issuers that substantially outweigh any potential incremental informational benefit to investors. Such burdens and costs include compliance costs to manage the reporting requirements, notably in the time and expense required to prepare the requisite statements, as well as potential offering delays caused by the often-lengthy lead time required for the financial statements to be prepared. In our firm’s experience, we often see transactions structured to avoid the disclosure requirements in which the market does not place importance on disclosure, which results in a loss of investor protection as investors lose the benefits of SEC registration. Rethinking and amending the requirements of Regulation S-X would represent a better calibration to provide disclosure that investors would find relevant and useful while at the same time balancing the cost of compliance to companies.

Set forth below is our specific analysis with respect to each of Rules 3-05, 3-09, 3-10 and 3-16 of Regulation S-X.

Rule 3-05 of Regulation S-X – Financial Statements of Businesses Acquired or to be Acquired and Related Requirements.

Fundamentally, we believe that in many instances the financial statements required under Rule 3-05 do not provide information that is needed by a “reasonable investor” in making an investment decision. Notably, the equity markets trade without the information included in the financial statements from the signing of a definitive agreement until 75 days following the acquisition. During this period, investors are evaluating and making investment decisions without the aid of this information and do not appear to fundamentally misjudge the effect of an acquisition even without the financial metrics mandated by Rule 3-05. When this information is introduced to the market via disclosure on a Form 8-K, we are not aware of many instances where security prices moved as investors reacted to the newly-released information and changed

their expectations, demonstrating that this information does not significantly alter the 'total mix' of information made available.

We believe that the reason investors appear to not value this information is that Rule 3-05 of Regulation S-X currently has a number of limitations. As the Release notes, there are limits on the utility and relevance of pre-acquisition financial statements in assessing the future impacts of an acquisition on a registrant—specifically, pre-acquisition financial statements do not reflect the new basis of accounting that arises upon consummation, changes in management or various other items affected by the acquisition, items which are important to an investor making her investment or voting decision. Further, the restrictions on pro forma adjustments prohibit a registrant from reflecting other significant changes it expects to result from the acquisition and which would be of comparatively more importance to investors than purely historical data. Pro forma information also usually lacks comparative prior periods and is unaudited.

If the Commission believes such acquired company financial statements are indeed important to an investor's investment decision notwithstanding the absence of empirical evidence, we would recommend raising the percentage thresholds for significance tests and require audited financial statements of an acquired business only when the significance of the acquired business exceeds 30% rather than the current 20% limitation, as imposition of the costs of providing financial statements of acquired businesses is justified only at thresholds higher than those currently in place in recognition of the significant burden with respect to preparation of the financial statements and the corresponding impact on efficient access to the capital markets that are imposed by the lower thresholds. We have suggested a 30% rather than 20% threshold, which we believe to be more indicative of a disclosure trigger that investors would deem material, thus satisfying the motivations of Rule 3-05 to provide investors with information important to their investment decisions. This higher threshold level would accomplish the goal of reducing the burden of providing audited financial statements of acquired businesses without jeopardizing investor protection, protection which would still be provided by the higher threshold level, a level which is more likely to only provide information that is of substantial importance to investors. Although investors would receive less information about some business acquisitions, the benefits would outweigh that cost. If the threshold was raised accordingly, investors would only receive information in situations where an acquisition was likely to significantly alter the registrant's future financial operations. Mindful of the materiality concept for disclosure obligations, summarized or condensed financial data could also be required for certain transactions at a lower threshold.

In addition to raising the threshold for significance, we believe that the Commission should eliminate the significance test, particularly for pre-tax income. In our experience, this test often yields false positives in situations where the acquirer has low pre-tax income (due to e.g. high interest expense, etc.) and the target has no debt. We would suggest that this test be eliminated. Alternatively, the rules could provide that the Rule 3-05 financial statements can be omitted if an issuer reasonably believes the statements to not be material with a requirement that such a determination be accompanied by narrative disclosure why the statements are to be considered immaterial.

In addition, we believe the asset test can also lead to false positives. For example, many technology companies that were built organically do not have sizable assets, and so the purchase price for an acquisition may trigger significance even when the acquisition is small compared to the technology company's market capitalization. We would suggest that the total asset and investment tests include an alternative test for companies with publicly-traded equity

that would permit measurement of the purchase price or acquired assets against the registrant's equity market capitalization.

Such modifications would decrease registrants' costs and compliance burdens, including leading to reductions in expense, time and effort, because the instances in which financial statements of acquired businesses and the number of years for which such financial statements are required would be reduced, enabling issuers/registrants to avoid the cost of preparing and auditing those statements. The costs to comply with Rule 3-05 are unnecessarily high compared to the limited informational benefits of the required disclosure. A revision of these disclosure obligations specifically with respect to registration statements would provide issuers greater flexibility and efficiency in accessing the public securities markets.

Rule 3-09—Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons and Related Requirements.

Rule 3-09 of Regulation S-X currently has a number of limitations. Notably, Rule 3-09 financial statements may be presented using different accounting standards, fiscal year-ends and/or reporting currencies than those used by a registrant. Rule 3-09 financial statements are also required only for significant investees rather than all investees that may affect a registrant's financial statements. As a result, they often cannot be reconciled to the amounts recognized in a registrant's financial statements for that investee**.**

More fundamentally, we believe that Rule 3-09 financial statements (separate financial statements of significant equity method investees) are irrelevant from an investment perspective as evidenced by the fact that these financial statements are routinely omitted in unregistered offerings. A registrant's financial statements alone provide financial information sufficient for a reasonable investor to make an informed investment decision, because the summarized financial information required by Rule 4-08(g) of Regulation S-X (that is, summarized balance sheet and income statement information on an aggregate basis for all investees) as opposed to individual reports is also adequate and would be just as useful to investors as separate financial statements. This summarized financial information is suitable for disclosure purposes in light of the information we have seen sophisticated investors request be included in offering documents. If the Commission is not prepared to omit Rule 3-09, we would recommend increasing the threshold for requiring summarized financial information, for example providing that separate audited financial statements of equity method investees should not be required unless the equity investee is significant at a substantially higher significance level. Such a change would ease reporting burdens while still ensuring meaningful disclosure to investors. In addition, a registrant should be able to exclude the financial statements it determines that the investment is immaterial (notwithstanding the possible satisfaction of any significance tests). The Commission could require that the rationale behind such a determination be disclosed in order to provide investors with more important and tailored information.

Article 10 of Regulation S-X (S-X Rule 10-01(b)(1)) should also not require summarized interim income statement information of individually significant Investees. GAAP does not explicitly require any disclosures about equity method investees in interim financial statements.

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

As noted above, Rule 3-10 information is routinely omitted in unregistered offerings. If institutional investors do not believe that condensed consolidating financial information is necessary to informed investment decision-making, it weighs in favor of removing the requirement as there do not appear to be other types of investors or market participants for which such information would be useful. Issuers and initial purchasers do not believe this information is relevant for investors and investors do not consider the information to be material. Accordingly, such information is not material to an investment decision and should not be required. Further, the requirements imposed by Rule 3-10 leads to issuers electing to do more unregistered as opposed to registered deals in order to circumvent the burdensome requirements. We would advise the Commission to consider replacing Rule 3-10 with a requirement to present revenues, a metric of earnings (which the issuer should be able to choose), assets and liabilities of the non-guarantors as a single group (which is the type of information typically included in Rule 144A offerings) as opposed to the financial statements currently required under Rule 3-10.

Additionally, we believe that the parent company's requirement to provide consolidating information during the period in which the guaranteed securities are outstanding should be modified. Registrants should be permitted to cease complying with Rule 3-10 once the debt securities are held by fewer than 300 record holders and the registrant files a Form 15 to suspend its Exchange Act reporting obligations as opposed to until the subject securities are no longer outstanding.

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

Under Rule 3-16 of Regulation S-X, full financial statements are required for pledgors whenever the securities of the pledgor constitute a "substantial portion" of the collateral. Separate financial statements are considered necessary for an assessment of the ability of an entity to satisfy its commitment in the event of default by the registrant.

For Rule 3-16 financial statements, this burdensome requirement to produce separate audited financials for large subsidiaries if their stock is pledged to secure a bond deal often makes it uneconomical to secure publicly offered bonds with stock pledges. 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 doing unregistered deals. The market practice for registered secured transactions is to prohibit or eliminate pledges of subsidiary capital stock if the pledges would trigger the requirement to provide separate financial statements under Rule 3-16, which reduces the collateral available to investors. Alternatively, market practice is to have secured offerings be conducted under Rule 144A, where no financial statements are included. As institutional investors, when making an investment decision, do not believe separate financial statements are necessary to evaluate the ability of the entities providing security to satisfy their commitments in the event of default by the registrant, it is hard to contemplate that there are other types of investors for which this information be would be useful to an investment decision.

Alternatively, Rule 3-16 could focus on value of the equity that is pledged only by non-guarantors and require a sentence of disclosure as to its book value (as equity pledged by guarantors is

irrelevant since the guarantor has provided a debt obligation) or permit registrants to provide summarized financial information about entities providing substantial security (in lieu of the separate financial statements required by Rule 3-16). This should give investors a sufficient understanding of the collateral position and financial condition of such entities.

In summary, we do believe that the current financial disclosure requirements in Regulation S-X for third parties can be modified substantially to better support the dual goals of the Disclosure Effectiveness Initiative of streamlining disclosure requirements for public companies while improving the clarity, relevance and usability of disclosure for investors. We believe the compliance burdens and costs imposed by Rules 3-05, 3-09, 3-10 and 3-16 are onerous and outweigh any incremental informational benefits to investors and should be revisited to better accommodate the needs of all market participants. Specifically, we believe the Commission should consider amending Rule 3-05 of Regulation S-X to modify the tests at higher threshold levels and permit registrants to omit the currently required financial statements so long as the effect of omitting the information would not be misleading and the omission of such financial statements would not render the registrant's financial statements substantially incomplete or misleading. With respect to Rules 3-09, 3-10 and 3-16, we believe that Rule 3-09 and Rule 3-16 should simply be deleted, and Rule 3-10 should only require limited quantitative disclosure of the amount of revenue, earnings (using a metric deemed relevant by the issuer), assets and liabilities held by non-guarantors, which is consistent with practice in unregistered deals.

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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, Richard D. Truesdell, Jr. or Joseph W. Clementz of this firm at 212-450-4000.

Very truly yours,

Davis Polk & Wardwell LLP